Who Will Pay For Your Retirement?

The Looming Crisis

A Statement by the Research and Policy Committee of the Committee for Economic Development

CED

Form **5500-C/R** | **Return/Report of Employee Benefit Plan** | OMB No. 1210-0016

For the calendar plan year or fiscal plan year

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EP–ID

A This return/report is for: (1) ☐ the first return/report for the plan; (2) ☐ an amended return/report; (3) ☐ the final return/report filed for the plan; or (4) ☐ a short plan year return/report (less than 12 months)

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B Check here if any information ☐

C If your plan year changed since last return/report ☐

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2a Name and address of plan administrator

3 If you are filing this page without the plan sponsor or plan administrator has changed since last return/report on lines 3a and/or 3b and complete line 3c.

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4 ENTITY CODE. (If not shown, enter applicable code.)

5a Name of plan ▶

All filers must complete 6a through 6d, as applicable.

6a ☐ Welfare benefit plan 6b ☐ Pension benefit plan

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6c Pension plan features. (If the correct codes are not preprinted below, enter the applicable pension plan feature codes from page 9 of the instructions in the boxes.)

6d ☐ Fringe benefit plan. Attach Schedule F (Form 5500). See instructions.

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Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this return/report, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of employer/plan sponsor ▶ Date ▶

Type or print name of individual signing for employer/plan sponsor

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Type or print name of individual signing for plan administrator

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RESPONSIBILITY FOR CED STATEMENTS ON NATIONAL POLICY

The Committee for Economic Development is an independent research and policy organization of some 250 business leaders and educators. CED is nonprofit, nonpartisan, and nonpolitical. Its purpose is to propose policies that bring about steady economic growth at high employment and reasonably stable prices, increased productivity and living standards, greater and more equal opportunity for every citizen, and improved quality of life for all.

All CED policy recommendations must have the approval of trustees on the Research and Policy Committee. This Committee is directed under the bylaws which emphasize that "all research is to be thoroughly objective in character, and the approach in each instance is to be from the standpoint of the general welfare and not from that of any special political or economic group." The Committee is aided by a Research Advisory Board of leading social scientists and by a small permanent professional staff.

The Research and Policy Committee does not attempt to pass judgment on any pending specific legislative proposals; its purpose is to urge careful consideration of the objectives set forth in this statement and of the best means of accomplishing those objectives.

Each statement is preceded by extensive discussions, meetings, and exchange of memoranda. The research is undertaken by a subcommittee, assisted by advisors chosen for their competence in the field under study.

The full Research and Policy Committee participates in the drafting of recommendations. Likewise, the trustees on the drafting subcommittee vote to approve or disapprove a policy statement, and they share with the Research and Policy Committee the privilege of submitting individual comments for publication.

Except for the members of the Research and Policy Committee and the responsible subcommittee, the recommendations presented herein are not necessarily endorsed by other trustees or by the advisors, contributors, staff members, or others associated with CED.

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*Voted to approve the policy statement but submitted memorandum of comment, reservation, or dissent. See page 82.

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PURPOSE OF THIS STATEMENT

Major reforms are needed in policies that affect both private retirement plans and Social Security if the United States is to avoid a serious crisis in retirement funding and living standards in the next century. Our goal in preparing this report is to show as clearly as possible the consequences of inadequate retirement saving for those retiring early in the next century and thereafter. If policies and practices are not changed, many twenty-first–century retirees will experience an unexpected and substantially reduced standard of living, due in no small part to a retirement system that is underfunded, overregulated, and soon to be strained as never before with the retirement of the baby-boom cohort.

Who Will Pay for Your Retirement? issues a strong warning, but it also offers comprehensive, specific, and workable recommendations. These recommendations, if taken together, will not only allow the nation to avert disaster but will also:

- Strengthen and streamline the way we fund and regulate retirement programs.
- Educate workers and employers about retirement needs, and provide incentives for people to save adequately for their own retirement.
- Significantly broaden the scope and coverage of private plans.
- Preserve Social Security for generations to come by improving funding and limiting the growth of benefits.

We are keenly aware of the enormous impact that retirement policies have on national saving and the economy. Decisions on retirement policies should place top priority not only on coverage and increased benefits but also on national saving, capital formation, and economic growth.

The Committee for Economic Development has a long-standing interest in retirement policies. In 1981, CED issued *Reforming Retirement Policies*, which outlined a strategy for broadening the reach of private pensions, increasing individual saving, and strengthening Social Security. Although a number of the recommendations in that report have been implemented (e.g., a gradual rise in the retirement age), recent changes in federal regulation (many made in the name of deficit reduction or antidiscrimination policy) have curtailed new pension formation and sound funding.

With this policy statement, we call on Congress to reverse government policies that are strangling private pensions and threatening their financial soundness. Although this statement deals primarily with policy for private pensions, we also say that Social Security cannot be ignored and that changes are necessary to preserve that system well into the next century. We call on all Americans to educate themselves about their retirement needs and options so that they can make sound and sensible decisions for themselves and their families.

ACKNOWLEDGMENTS

I want to thank the very able group of CED Trustees and advisors who served on the CED subcommittee that prepared this report (see page viii).

Very special thanks are due to the subcommittee's chairman, Lawrence A.Weinbach, Managing Partner-Chief Executive of Arthur Andersen & Co, for the energy, expertise, and wisdom he brought to this project. We are also indebted to Project Director William J. Beeman, CED's Vice President and Director of Economic Studies, not only for his comprehensive knowledge but also for the clarity he has brought to this complex set of issues.

Thanks are also due to CED Economist Michael Baker for his contributions to this project and to Carol Alvey for her secretarial assistance.

We are deeply grateful to Merrill Lynch and Company, the New York Life Foundation, Morgan Stanley Group Inc., John Hancock Mutual Life Insurance Company, Lincoln National Corporation, the Investment Company Institute, Household International, and Towers Perrin for their generous support of this most important program.

Josh S. Weston
Chairman
CED Research and Policy Committee

Chapter 1

Executive Summary and Policy Recommendations

America's retirement system is underfunded, overregulated, and soon to be challenged by unprecedented growth in the retirement-age population. Consequently, our nation will confront a major crisis in financing the needs of the elderly at the beginning of the twenty-first century unless policies are reformed to make retirement saving a top priority. If steps are taken promptly to implement the reforms recommended by CED in this statement, significant sacrifices will be required, but they will be manageable. If action is postponed, the nation will face the very unpleasant choice of a substantial cut in the economic status of the elderly or an economically damaging and unfair tax burden on future generations of workers.

The economic well-being of future retirees and, indeed, of workers is seriously at risk because of the interaction of several demographic, economic, and fiscal trends:

- Growth in the elderly population in the United States, which is already quite rapid because of increasing life expectancy and declining fertility rates, will accelerate when the baby-boom generation reaches retirement age in about a decade. A sharp decline in the ratio of workers to retirees will result.[1]
- Private saving for retirement is woefully inadequate, and national saving has declined.
- Underfunded pension promises in both private and public retirement programs are a growing and often understated problem.
- Rapid growth in government spending for the elderly threatens to get so far out of control when the baby-boom generation retires that it cannot be financed by reasonable burdens on taxpayers.

Private saving is only a fraction of that needed to enable future retirees to fulfill their economic expectations in retirement. One recent study showed that the baby-boom generation needs to triple its rate of accumulation of assets in order to maintain its preretirement living standard during retirement. Moreover, this projection assumes that Social Security benefits will not be cut.[2] But it is now clear that the Social Security system has made promises to future retirees that cannot be kept without vastly improving prefunding or imposing a harsh burden on future workers. This situation has been exacerbated by ill-advised changes in regulatory and tax policies that have discouraged private saving for retirement and by federal budget policies that have generated huge deficits. These deficits continue to absorb the lion's share of private saving needed to ensure the economic prosperity of future citizens.

Clearly, for the vast majority of those currently in the labor force, their future economic circumstances will depend greatly upon their own saving and participation in retirement plans. Those who are not making sufficient preparations for retirement appear to have a misunderstanding about the impact of undersaving on their retirement income. **CED believes that this situation calls for a major education campaign sponsored by both gov-**

ernment and private employers to improve workers' understanding about their own responsibilities and options for retirement.

Although the primary focus of this policy statement is private retirement programs, we recognize that private saving is only one component of the retirement finance problem. Therefore, our discussion of retirement saving would not be complete without a brief examination of the problem of underfunded promises with respect to Social Security and pensions for public employees. Indeed, the outlook for Social Security makes reform of private retirement policies all the more important.

The major thrust of the reforms recommended by CED can be described as follows:

- The federal government should streamline and simplify regulation and reverse recent changes in regulatory and tax policies that act as barriers to private retirement saving and discourage growth in private pension coverage.
- Businesses and government sponsors of retirement programs should fully fund pension promises made to their workers and avoid making promises that cannot be kept. Business and government should also encourage an increase in the average retirement age in recognition of the improved health status of the elderly and the projected need for skilled workers, and to compensate for added retirement costs arising from increases in life expectancy.
- In order to encourage individuals to increase their saving and take greater responsibility for their future, workers must be better educated about the effects of retirement saving and the choices they make about retirement ages, saving rates, and investment strategies on their future economic circumstances.
- Government should quickly legislate the gradual introduction of benefit-trimming changes in Social Security in order to preserve the long-run financial health of the system. Social Security retirement benefits and other benefits for the elderly should not be promised if they cannot be financed either by advance funding *that adds to national saving* or by an acceptable level of taxes on active workers.

We believe that the nation must act quickly to reform retirement policies and practices so that the future economic security of retirees and all other citizens will be protected. Postponing action would simply raise the cost dramatically; in contrast, early action implemented in gradual steps would minimize the impact on the living standards of both workers and retirees.

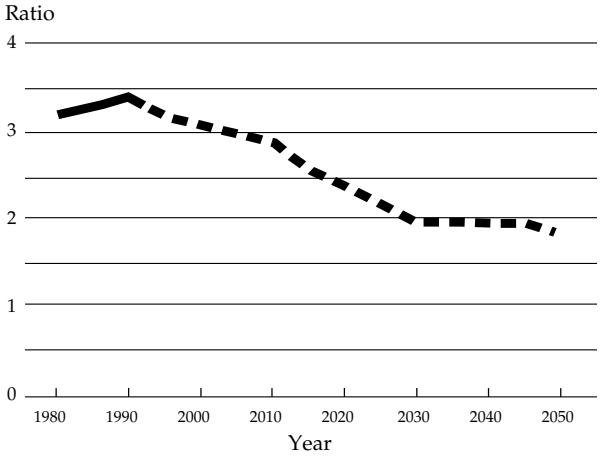
THE CHALLENGE POSED BY AN AGING POPULATION

Growth in the nation's real income and wealth has made it possible for the United States not only to provide for the basic needs of rapidly growing numbers of elderly but also to greatly improve their economic well-being. However, because of the aging of the baby-boom generation, the retired population will begin to rise much more rapidly and the workforce more slowly during the first decade of the next century. The ratio of workers to retirees is expected to plunge from its current level of about 3.4 to 1 to about 2 to 1 by 2030 (see Figure 1).[3] Consequently, providing for the needs of growing numbers of elderly will become a much greater challenge for the country. The share of the nation's total output consumed by this group will increase, placing a heavy burden on workers unless the increased consumption by retirees is prefinanced by saving, including funded pensions. Unfortunately, federal regulations enacted since the mid-1980s have been inimical to funding. Moreover, legislation requiring the delay of a large part of funding until the later part of workers' careers, combined with the aging of the workforce (as the baby-boomers approach retirement), will raise the cost of many retirement plans sharply, thereby discouraging the expansion of retirement ben-

Figure 1

Ratio of Workers to Social Security Recipients, 1980 to 2050

(intermediate projection)



NOTE: "Workers" defined as persons having earnings creditable for Social Security.

SOURCE: Office of the Actuary, Social Security Administration.

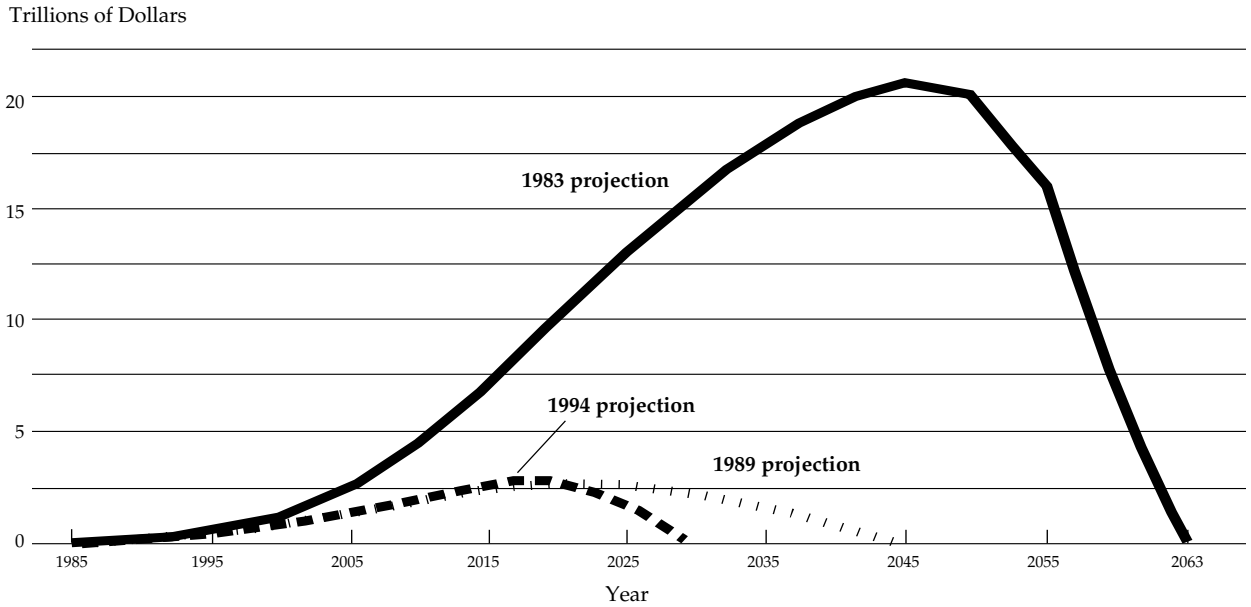
efits. Delay in funding was required by the Omnibus Budget Reconciliation Act of 1987 (OBRA 1987). See Chapter 5 and Figure 25 for a description of the effect on funding.

The upcoming bulge in the elderly population presents a particularly serious problem for Social Security. Some of the increase in spending for Social Security benefits can be financed by drawing down the reserve in the Social Security trust funds. However, this will merely delay a tax increase, and probably not for long. The Social Security Administration's intermediate projection indicates that the annual cash flow will turn negative beginning in 2013 and that the reserve fund will be exhausted in 2029. Because earlier projections of the balance in the Social Security retirement trust funds have been revised downward persistently and dramatically (see Figure 2), many believe it is more realistic to assume that the fund will run out much sooner, perhaps by 2012, as in the Social Security Administration's more pessimistic projection. When the reserves

Figure 2

Revised Intermediate Projections for Social Security Trust Fund Balances

(current dollars)



SOURCE: Office of the Actuary, Social Security Administration.

are exhausted, Social Security benefits must be financed by taxes on current wages (or by increased debt), placing a uniquely heavy burden on future workers.

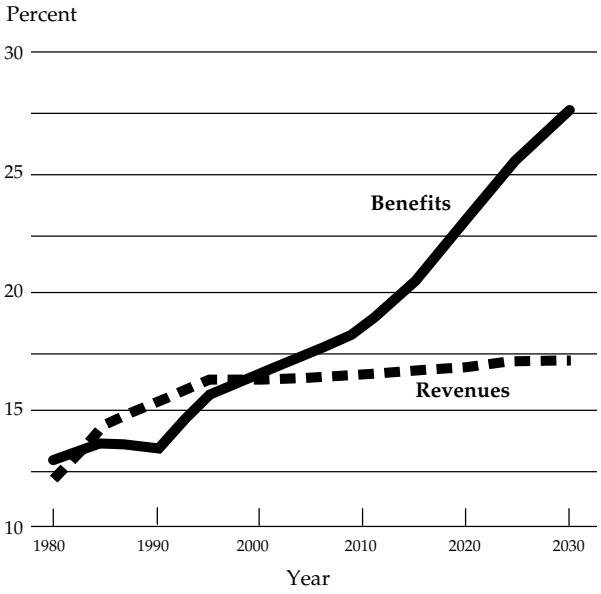
The actuarial deficiency in Social Security, taking into account all prospective revenues and expenditures for the next seventy-five years, was estimated at $1.9 trillion at the end of 1993.[4] A rough indication of the potential future burden of Social Security on active workers can be seen by comparing the cost of retirement benefits with the wages of workers. The Social Security Administration's 1994 intermediate projection indicates that total expenditures for old age and survivors insurance and disability and hospital insurance benefits, or OASDIHI,[5] which are financed by the payroll tax, will increase by an alarming 12 percent of taxable payroll (from more than 15 percent to nearly 28 percent) during the 1994–2030 period, largely as a consequence of demographic change (see Figure 3).[6] OASDIHI benefits are also projected to rise sharply as a share of the gross domestic product (GDP), from 6.4 percent in 1994 to 10.8 percent in 2030. These figures do not reflect the rapidly growing cost of supplementary medical insurance (SMI, or Part B of Medicare) that is financed primarily out of general tax revenues, the growth in unfunded retirement benefits from government jobs that will also be financed from general revenues, and other programs for the elderly for which long-term projections are not available.[7] Thus, it is not surprising that many have concluded that government-related retirement and health benefits for the elderly must be cut back. In CED's view, reliance on extremely high taxes paid by future workers to finance these benefits for the elderly would be very inequitable and have an extremely adverse effect on the living standard of those workers born after the baby-boom generation.

The impact of demographic change on pay-as-you-go retirement financing makes it imperative that pension policy be reformed to encourage increased retirement saving and to reduce unfair shifting of the burden to future generations of workers. Senator Robert Kerrey and former Senator John Danforth, co-chairmen of the Bipartisan Commission on Entitlement and Tax Reform, have responded to the Social Security projections by proposing fundamental changes in Social Security and the U.S. retirement system that would bring future outlays and revenues to near balance. However, there is substantial political resistance to changes in Social Security at the present time, although reform is critically needed and delaying action will only make the problem worse.[8] But given the unavoidable impact of the aging population on pay-as-you-go retirement systems, **the most promising way to protect the economic security of future retirees without overburdening workers is to increase *private* retirement saving.** Many individuals look upon contri-

Figure 3

Social Security Retirement and Hospital Insurance Benefits and Revenues, 1980 to 2030

(percent of taxable payroll)



NOTE: Revenues exclude interest on trust funds.

SOURCE: Office of the Actuary, Social Security Administration.

butions to their pension funds, which are their own assets, as much less of a burden than increased payroll taxes. If policy changes succeed in encouraging individuals to forgo a significant amount of consumption before retiring, and if sponsors of retirement programs fully fund pension promises, the income of retirees can be maintained without an unacceptable sacrifice by workers.

THE UNTIMELY DECLINE IN RETIREMENT SAVING

Unfortunately, saving for retirement and other purposes has declined in the United States at the very time when it should be rising in anticipation of the retirement of the baby-boom generation. Private contributions to pensions as a percent of disposable income have declined in the last decade, though not as sharply as total personal saving (see Figure 4).

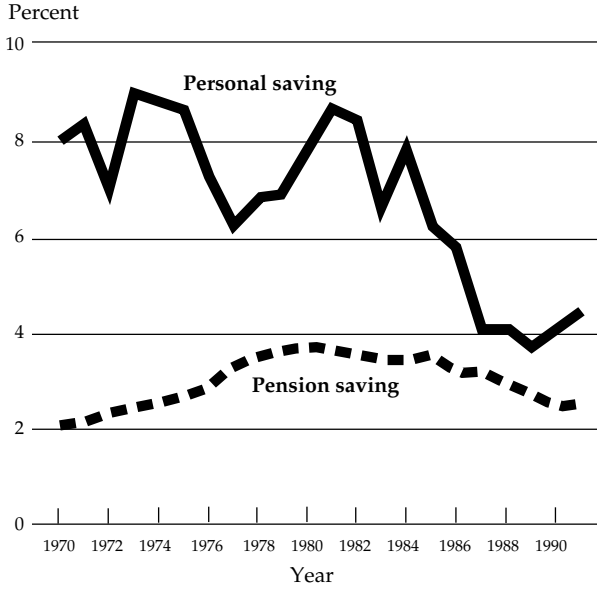
PENSION CONTRIBUTIONS AND FUNDING

Total private pension contributions declined in constant 1987 dollars from about $1,470 per worker in 1985 to about $1,140 per worker in 1991. The employer component declined in real terms from about $1,039 in 1980 to about $506 per worker in 1991 (see Figure 5). Defined benefit plans, which are more commonly sponsored by large firms, suffered a very sharp decrease in contributions (see Figure 6).[9] Overall contributions by employers to these plans declined largely as a consequence of three developments: (1) increased earnings on financial assets, (2) the enactment in 1987 of lower ceilings on pension funding eligible for tax deductions, and (3) a sharp rise in the cost of complying with increasingly complex regulations that discouraged the growth of defined benefit plans, particularly in small firms (see Figure 7). Total

Figure 4

Personal and Pension Saving, 1970 to 1991

(percent of disposable personal income)

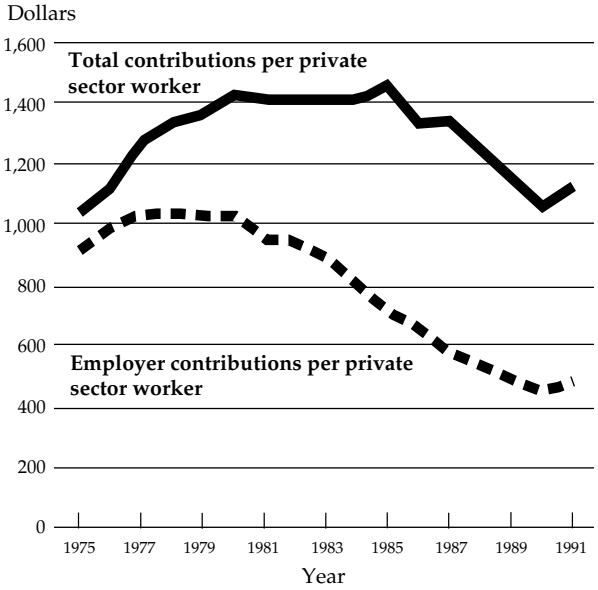


SOURCE: Bureau of Economic Analysis; pension saving series provided by staff at The Brookings Institution.

Figure 5

Decline in Contributions to Private Pension Plans, 1975 to 1991

(in 1987 dollars)

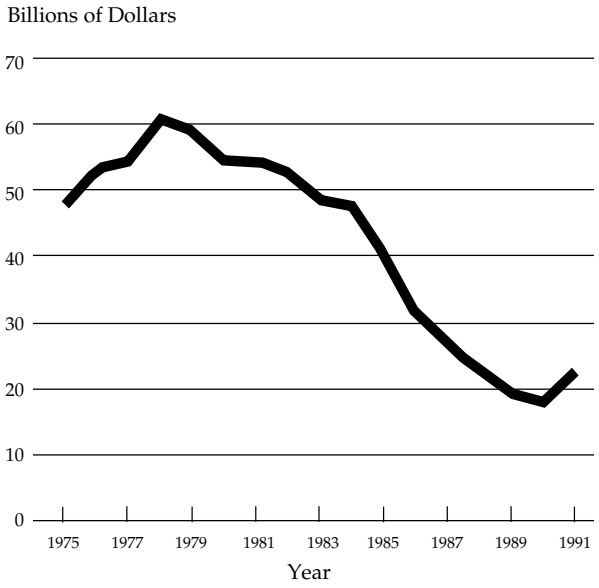


SOURCE: The Brookings Institution, Bureau of Labor Statistics, Bureau of Economic Analysis.

Figure 6

Employer Contributions to Defined Benefit Plans, 1975 to 1991

(in 1987 dollars)



SOURCE: Pension and Welfare Benefits Administration, U.S. Department of Labor.

contributions to defined contribution plans continue to rise, however, as a consequence of rapid growth in plan participation.

Underfunding of defined benefit pension plans is a serious problem. Although most private pensions meet legal funding requirements, CED believes that the funding limits enacted in the 1980s (described in detail in Chapter 5) have placed many pension funds at risk in the event of unexpected changes in the value of financial assets and in the financial strength of firms. A decline in interest rates, for example, would reduce the return on pension assets and increase the present value of future benefits, thereby causing some pensions to become underfunded. Moreover, the funding status of private pensions has deteriorated even by current legal funding standards. Underfunding of private retirement plans has been increasing rapidly, reaching $71 billion in 1993, according to the Pension Benefit Guaranty Corporation (PBGC),[10] a federal agency that insures private pensions. It should be noted that this insurance program also exposes future taxpayers to a huge potential liability.[11]

Information on underfunding of government employee pensions is incomplete, but the magnitude of underfunding appears to be greater than for private pensions. (Of course, the government's taxing authority makes it difficult to compare the risks.) It has been estimated that the average funding ratio of all state and local pensions is only 80 percent and that the actuarial deficiency for federal, civilian, and military pensions at the end of 1992 was $1.5 trillion, taking into account both prospective receipts and outlays.[12]

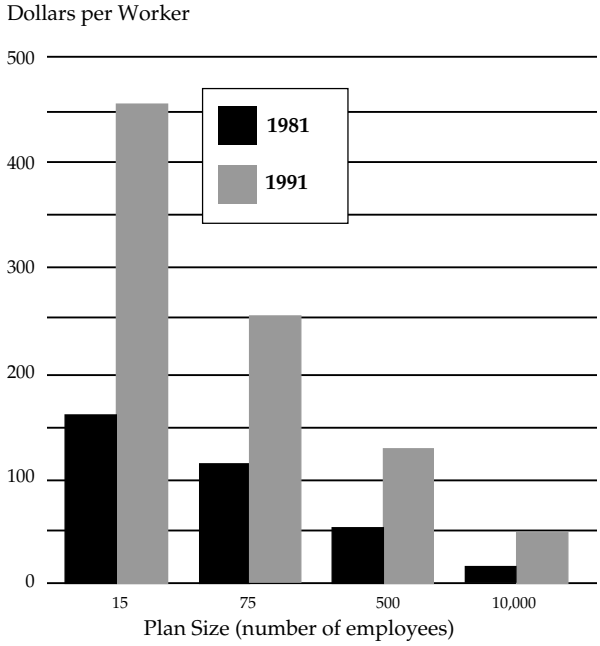
ECONOMIC EFFECTS OF DECLINING RETIREMENT SAVING

The decline in retirement saving not only jeopardizes the economic security of individual

Figure 7

Regulatory Costs Have Soared

(administrative costs for defined benefit plans in 1990 dollars)



SOURCE: Hay/Huggins Company, Inc.

workers but also affects the economic health of the country, because retirement saving is a very large and growing component of national saving. The U.S. *national saving rate* (the sum of saving for retirement and all other purposes by individuals, business, and government) has fallen to record low levels in recent years. In fact, the national saving rate has averaged less than 2 percent of GDP so far in the 1990s, down from 4 percent in the 1980s and about 8 percent in previous decades. Because national saving is the domestic source of funds for investment, its decline has an adverse effect on U.S. productivity growth and international competitiveness. Moreover, the rate of saving has been low for some time, and the cumulative effect on the nation's capital stock cannot be reversed quickly. Of course, weak growth in productivity and real wages does not bode well for the living standard of future retirees and workers.

POLICY OPTIONS TO TACKLE THE RETIREMENT FINANCE PROBLEM

There are limited options for alleviating the burden on future workers arising from the inevitable increase in the elderly population. The most important is to make retirement saving and adequate funding of pensions top priorities for individuals, employers, and government. Retiree spending from retirement saving (including benefits received from funded pensions) is merely the recapture of deferred consumption. Unlike pay-as-you-go financing, this recapture need not be a burden on workers because the saving resulting from deferred consumption contributes to the growth of the economy and the growth of workers' real incomes. Indeed, if the added saving creates sufficient income to pay for the rise in benefits to retirees, active workers would experience no increased burden as the retiree population grows.

Therefore, the basic objective of retirement policy should be to ensure the economic security of retirees by encouraging retirement saving, full funding of pensions, and widespread pension coverage. Unfortunately, recent legislation appears to have been motivated by other concerns, such as the elimination of every potential abuse of pensions, the impact of pension saving on the distribution of income, and the budget deficit. All these concerns have merit but frequently cannot be addressed *through pension policies* without creating enormously complex and costly regulation and undermining the primary objective of retirement policy.

CED believes that the looming crisis in retirement finance requires the prompt implementation of three measures: (1) tax incentives and regulatory reform to encourage individual retirement saving and to achieve increased funding of, and coverage by, private pensions; (2) education programs that increase worker awareness of the need for retirement saving and encourage individual responsibility; and (3) changes in government priorities to provide full funding of public employee pensions, increased funding of Social Security, and a reduction in the growth of spending programs and promises for the elderly financed from current income.

REGULATORY REFORM FOR PRIVATE RETIREMENT PLANS

The objective of the 1974 Employee Retirement Income Security Act (ERISA), which remains the basic pension law of the United States and deals with all facets of private pensions, was quite simple: to protect the pensions of the elderly. However, numerous amendments have since been enacted that are extremely complex, in large part because of their diverse objectives. These changes have placed many barriers in the way of increased pension coverage and retirement saving. For example, complicated discrimination rules and funding limits enacted in the 1980s have sharply increased administrative costs, reduced contributions, and placed pensions at increased risk. From a national saving perspective, the most serious setback was OBRA87, which limited funding of defined benefit plans to 150 percent of plan *termination*

liability. (Termination liability is the liability a plan would incur if it were to cease at any given time. 150 percent of termination liability is generally lower than 100% of *projected* liability, which was the previous funding limit.) This change forced many firms to discontinue further funding of pensions for several years.

By discouraging retirement saving, these regulatory changes have clearly exacerbated the burden on future workers arising from demographic change. At the same time, regulators have failed to take adequate action to preserve existing retirement funds. Reforms are needed to reduce preretirement withdrawal of retirement funds for consumption purposes and to encourage improvements in the portability of pension funds.

CED believes that pension regulatory and tax policies must be streamlined and simplified and subjected to cost-benefit evaluation. We propose a number of changes in the regulation of private pensions that would greatly simplify discrimination rules, restore the full-funding limit to its pre-1987 level of 100 percent of projected plan liability, preserve pension funds for retirement, permit pension tax preferences to be based on lifetime income (as opposed to current-year income only), encourage accelerated vesting and greater portability of pension assets, increase the authority of the PBGC to make sure that sponsors of private pensions meet their funding responsibilities, and increase the limit on pension benefits and contributions (see "Summary of Policy Recommendations"). All our recommendations are designed to encourage saving and greater support for private retirement programs.

RETIREMENT INFORMATION AND INDIVIDUAL RESPONSIBILITY

Although reform of pension regulation is critical, **CED believes that it is incumbent upon individuals to take greater responsibility for financing their retirement.** Individuals ultimately pay for their own retirement by saving, participating in retirement plans, and paying taxes. We recognize, however, that workers are not well informed about retirement needs and benefits.[13] Indeed, financial literacy is low in the United States, and many workers do not have adequate information about retirement income and retirement options to plan intelligently for their old age. The fact that private retirement saving per worker may be only about one-third of what will be needed to maintain accustomed living standards during retirement does not appear to be widely understood by workers. **Therefore, CED recommends that government and business regularly provide all workers with information on accrued and prospective retirement benefits.** The Social Security Administration is planning to begin the distribution of such information soon. This is a positive development. It is critically important, however, that the information on Social Security be as realistic as possible, including the possibility that benefits may be cut in order to preserve the system. In this way, individuals can make informed plans for their retirement.

REFORMING GOVERNMENT EMPLOYEE PENSIONS AND THE SOCIAL SECURITY PROGRAM

It is also important to reform the funding of government employee pensions. Indeed, **CED strongly endorses the view that pension promises made by both private and public employers should be fully funded and that no promises should be made that cannot be funded.**

The specific character of required reforms in Social Security retirement programs is a complex issue beyond the scope of this statement. It is clear, however, that merely passing the burden to future generations is both inequitable and bad economics. **The increase in total benefit payments that will occur because of the baby-boom bulge should be prefinanced, and/or benefits should be cut to limit the burden on future workers. We also believe that the rise in life expectancy warrants a further increase in the normal**

retirement age beyond the increase already legislated and that the earnings limit for recipients of Social Security should be raised substantially in order to reduce the disincentive for the elderly to continue working. Of course, a politically realistic resolution of the Social Security financing problem is likely to involve both cuts in benefits, especially for higher-income individuals, and some additional taxes to increase prefunding of the retirement of the baby boomers. **CED has previously endorsed a proposal for full taxing of Social Security benefits in excess of the beneficiary's contributions.** (Because low-income retirees do not pay federal income taxes, the taxation of all benefits would have an effect somewhat similar to means testing of benefits.) **Other reforms, such as a gradual phase-in of a lower ratio of initial benefits to income and/or limits on the indexing of benefits (above the minimum subsistence level), should be considered.**

The economic status of retirees has improved sharply in recent decades, a development that has probably raised workers' expectations relating to retirement income. To the degree that workers regard promised Social Security benefits as a right, similar to a property right, that should not be repealed, there may be strong resistance to these options. Nevertheless, given the present state of preparations for retirement and the potential burden on workers, reduced benefits and delayed retirement are not likely to be matters of choice. However, the burden on future retirees can be minimized by giving them adequate warning. **CED believes that necessary reductions in future Social Security benefits should be enacted well before they take effect in order to give workers an opportunity to make compensating adjustments in their saving behavior.**

Such reforms would permit a larger buildup in Social Security trust fund reserves and reduce the potential burden on future workers by making it possible to hold down payroll tax rates when the baby-boom generation retires. However, the effect on the payroll tax may be a misleading indicator of the future burden if the increased reserves do not add to national saving. No additional resources are created to pay for the rise in benefits unless the reserves add to national saving, productive capital, and economic growth. Unfortunately, it appears that the recent positive cash flow in the Social Security program has been used to pay for current government services rather than to add to saving. **CED believes it is imperative that the positive cash flow in the Social Security program be used, not to support government consumption, but to add to national saving.**

SUMMARY OF POLICY RECOMMENDATIONS

The economic well-being of future retirees and their dependents is in jeopardy because of the continuing failure of our society to make adequate preparation for an inevitable sharp rise in the retirement-age population. This situation is reflected in the low priority many individuals give to retirement saving, changes in regulations that have discouraged or limited contributions to retirement plans, underfunded pensions sponsored by both public and private employers, and a looming crisis in the Social Security retirement system, which has promised future benefits that cannot be provided without imposing a harsh burden on future generations of workers. Unfortunately, the regulation of private pensions has become incredibly complex and aimed at various social objectives that often conflict with the goal of encouraging retirement saving. **CED believes that policy makers should focus much greater attention on the basic goal of retirement policy, which is to ensure the economic security of the elderly by encouraging saving for retirement.**

The adverse effects of government policies on retirement saving and work effort have led

us to the conclusion that current pension laws, regulations, and practices must be streamlined, simplified and designed to achieve six basic objectives:

- **Provide retirement plans for the largest possible number of workers.**
- **Ensure that pension plans meet appropriate fiduciary standards and are funded to fulfill pension promises.**
- **Encourage individual saving by making retirement saving opportunities available to all workers through deferred taxes on contributions and earnings and by providing all workers with realistic information on their retirement saving needs, resources, and options.**
- **Place simple and reasonable limits on tax preferences received by any individual (i.e., a single overall limit on eligible contributions indexed to inflation and a limit on benefits received from a qualified defined benefit plan).**
- **Preserve retirement saving and pension rights by discouraging preretirement withdrawals and by improving the portability of pension assets.**
- **Compensate for the rise in life expectancy by encouraging retirement at a later age and by reducing work disincentives for the elderly who receive retirement benefits.**

Both business and government should encourage later retirement in order to compensate for the rise in life expectancy, and government should raise the earnings limits applicable to retirees receiving Social Security benefits. Although government tax and regulatory policies should encourage private pension saving, we believe that tax incentives should be carefully designed to ensure that they raise national saving as well. Pension saving for retirement represent a large and increasingly important component of national saving. Other legitimate fiscal policy concerns, such as the budget deficit, should not be addressed in a manner that serves to exacerbate our private saving deficiency. In addition, other important retirement policy issues should not be addressed in a way that defeats the basic saving objective of pension policy.

The inadequacy of present-day retirement saving may be due in part to confusion about who is responsible for meeting the income goals of retirees. Apparently, some individuals mistakenly believe that their income in retirement is entirely or principally the responsibility of government and business. **In fact, the responsibility for the income of retirees is divided among government, employers, and individuals. However, each individual must bear the ultimate responsibility for his or her living standard in retirement.** *Social Security*, which is only loosely linked to income, should continue to provide a minimum level of retirement income for all working members of society and their dependents. *Businesses and other employers* should be encouraged to voluntarily facilitate and assist saving for retirement to the degree affordable. Company-sponsored pensions are often useful as a means of attracting and retaining a competent workforce. Employer plans, combined with Social Security, are generally intended to provide retirees with a reasonable minimum standard of living, though with less income than received by active workers. Finally, *saving by individual workers* should be encouraged so that they can achieve their desired living standard in retirement. For many workers, their savings are a critical source of retirement income.

CED continues to favor strong action to reduce the federal deficit as the most certain way to increase national saving needed to improve the growth and competitiveness of the U.S. economy. Some of the recommendations presented in this statement would reduce the federal deficit; others would raise it. We believe that any net increase in the federal deficit resulting from reform of retire-

ment policies should be offset by reductions in real spending. However, the purpose of reducing the deficit is to increase national saving; therefore, attempts to lower the deficit by taxing private saving are counterproductive and should be avoided.

With these goals and responsibilities in mind, CED makes the following recommendations:

1. Retirement plan nondiscrimination rules governing coverage and contributions should be streamlined and simplified in a manner that reduces administrative costs and increases saving for retirement and coverage.

Nondiscrimination rules in general, including coverage rules and nondiscrimination tests relating to contributions under Sections 401(k) and 401(m) of the Internal Revenue Code, are complex and extremely costly to administer. These tests reduce pension saving by middle-income earners as well as more highly compensated employees. With appropriate grandfathering of rules where necessary, these tests should be replaced by a vastly more simple and administratively inexpensive safeguard against discrimination:

- **All employees who meet nondiscriminatory age and service eligibility requirements should (a) be covered and (b) receive the *same ratio* of employer contributions to wages. (In the case of defined benefit plans, the same benefit formula should be applied.)**

If such a radical reform cannot be adopted in its entirety, simplification should proceed along the following lines:

- **Employers who *voluntarily comply* with the two nondiscrimination standards specified in the preceding bullet would be given safe harbor from all further nondiscrimination tests, such as those under Sections 401(k) and 401(m) of the Internal Revenue Code.**
- **Employers who do not comply with both the coverage and the uniform contribution standards mentioned above should, at a minimum, adopt the coverage rule.**
- **Top-heavy rules, which are already largely redundant in view of the nondiscrimination rules in place for all pension plans, should be eliminated.**
- **Restrictions on the employer's ability to integrate private pension benefits with Social Security should be eliminated in cases where the employer contribution for all employees equals or exceeds an appropriate threshold.**

2. Federal regulation should encourage full funding of private pensions.

One of the most important causes of declining business contributions to pensions is OBRA87, which capped funding for defined benefit plans at 150 percent of termination liability. As a consequence of this legislation and rising asset values, many firms were unable to make eligible contributions for several years. Firms can only ensure the viability of their defined benefit plans if they are permitted reasonable flexibility to spread the costs of funding plans over time in a manner that realistically reflects both expected plan liabilities and the firms' ability to make contributions. The full-funding limit based on termination liability denies such flexibility and places a disproportionate burden on the firm in the later years of workers' careers.

- **The full-funding limit should be restored to its pre-1987 level of 100 percent of projected plan liability. Projected plan liability in the case of flat-dollar defined benefit plans should be calculated to include anticipated increases in the dollar benefit level that are negotiated over time.**

3. Business and government should provide workers with adequate and realistic information about their pensions and Social Security benefits.

Many individuals reportedly undersave because they are not adequately informed

about accumulated benefits, retirement needs, and the rate of saving required to meet those needs. Individuals can prepare intelligently for their retirement only if they have sufficient information about their retirement needs and resources as well as their saving and investment options. Some employers are reported to be reluctant to provide information on prospective growth of funds because they fear that they could be liable for the outcome.

- **Workers should be given realistic information about retirement needs, accumulated and projected benefits, the effect of different investment choices on their retirement income (if they have control over such choices), and the funded status of their plan (if it is a defined benefit plan).**
- **The Department of Labor should provide guidance designed to encourage employers to provide information on retirement saving and investment to their employees and to protect plan sponsors against unreasonable lawsuits. For example, information provided by employers about *past* market performance should not make employers legally liable if *future* performance is inconsistent with experience.**

4. Regulation should encourage both the preservation of retirement funds until the worker retires and the portability of pension assets.

Preretirement withdrawals from pension funds are placing the economic security of future retirees in jeopardy. Although some of these withdrawals are used for investment purposes such as education and housing, a large proportion is simply used for current consumption. CED recommends:

- **In-service preretirement withdrawal and borrowing of *employer* contributions to pension plans should be prohibited. Access to voluntary *employee* contributions should *not* be prohibited, but existing penalties should be retained.**
- **Regulators should investigate options for accelerating vesting and for improving the portability of vested benefits from defined benefit plans. Individuals who change employers should be strongly encouraged to roll over preretirement lump-sum distributions into alternative retirement saving instruments such as individual retirement accounts (IRAs) and defined contribution plans maintained by their new employers.**

5. In order to increase saving for retirement and to encourage small-business owners and managers to provide pension plans for all employees, Congress should raise the annual limit on allowable plan contributions and benefits to more reasonable levels.

Regulations limiting both contributions and benefits are often redundant and tend to reduce pension contributions and saving, leading to the abandonment of some plans and discouraging the formation of new ones. Limits on benefits also discourage higher-risk investments. The following reforms should be made:

- **Retirement saving tax preferences should be based on accumulated lifetime income rather than current-year income only. This would be a stimulus to saving and far more equitable, particularly for those who must postpone contributing because of unusual expenses (such as medical expenditures) or because of a temporary absence from the workforce (such as parents caring for children).**
- **With respect to the redundancy of restrictions on benefits and contributions, limits on tax preferences for contributions are generally preferable to restrictions on benefits. Therefore, the excise tax on annuitized pension distributions above a stated threshold (now $148,500 for a single employee) should be eliminated, and the limit on benefits from a qualified defined benefit plan (now $118,800) should be raised.**

- **Given the proposed elimination of excise taxes on distributions, a limit on total contributions and on considered compensation should be retained. However, the considered compensation limit (now $150,000) should be raised at least to its pre-OBRA93 level[14] (and indexed); to prevent contributions for lower-income workers from declining, the limit on considered compensation should apply only to those whose incomes actually equal or exceed that limit, not to those whose *projected* incomes equal or exceed it. The dollar limit on total contributions should also be increased.**
- **Congress should discontinue the recent practice of reducing considered compensation for more highly compensated employees as a means of raising federal revenue. This is necessary because of its adverse effect on pension saving, through its impact on contributions for lower-income employees and on the willingness and ability of sponsors to create and maintain qualified plans.**
- **Individual contributions to 401(k) plans that are *primary* pension plans should be subject to the same limit that applies to other defined contribution plans, such that the combined employee and employer contributions do not exceed that limit. This will give workers in smaller firms an opportunity to expand their retirement savings and provide a greater incentive for managers of small firms to offer these plans to their workers.**

6. The Pension Benefit Guaranty Corporation reforms should improve both the solvency of the PBGC itself and the funded status of the pension plans it insures. Thus, the PBGC premium structure and benefit guarantee should be aligned more closely with the actual risk posed by a pension plan and the PBGC should have stronger compliance authority to insure adequate funding levels. Amortization periods for unfunded liabilities should be simplified and shortened.

The PBGC's poor financial position has three underlying causes: (a) Premiums for risky plans are set too low. (b) Premiums are structured in a way that creates an adverse-selection problem in the insurance pool. (c) The PBGC's compliance authority is weak and there is insufficient incentive for companies with underfunded pension plans to increase their funding. Minimum-funding rules also allow amortization of some kinds of unfunded pension liabilities over an excessively long period.

- **The PBGC insurance premium should be restructured so that it more closely resembles what would be offered in the private market. Such a redesign should include a stronger link between the premium level and the actual risk that a pension plan poses to the PBGC. For example, the premium calculation could take into account the financial strength of the plan sponsor, the marketability of plan assets, and the proportion of assets tied up in the firm's own equities.**
- **The PBGC should be given more power to influence the behavior of sponsors of underfunded plans, including the authority to prevent plans operating below a particular funded ratio from granting benefit increases to employees.**
- **The amortization schedules for unfunded liabilities should be simplified by reducing the number of categories, and the amortization periods should be shortened to accelerate the funding of liabilities.**
- **The PBGC's benefit guarantee structure should be revised to correlate more closely with the minimum-funding requirements attributable to specific benefits, such as shutdown benefits** (see Chapter 5).
- **The status of the PBGC's claims in bankruptcy should be reviewed and enhanced, as appropriate.**

7. Changes are required to place the Social Security program on a sound financial footing and avoid an unfair burden on future generations of workers.

Based on already-legislated benefits, projected demographic changes, and other factors, the Social Security Administration's long-run projections indicate that the program's assets will be depleted rapidly when the baby-boom generation retires unless benefits are cut and/or payroll taxes are increased sharply. This policy statement focuses on the regulation of private pensions and does not set out a detailed program for Social Security reform. However, the fiscal principles espoused by CED lead us to call for the following changes:

- ***All* Social Security benefits that exceed past contributions should be subject to income tax. We also believe that the age requirements for receiving normal retirement benefits should be raised beyond the increase already legislated and that the limits on earnings of retirees receiving benefits should be raised substantially. Congress should consider other limitations on Social Security benefits, such as reduced cost-of-living adjustments for benefits above a basic floor, and/or a gradual phase-in of a lower ratio of initial benefits to income.**
- **Steps should be taken to make sure that the building Social Security reserve funds do not serve to mask the non-Social Security federal budget deficit and that they result in an increase in real national savings.**

8. Defined benefit plans sponsored by federal, state, and local governments should be subject to minimum disclosure and funding standards. Plans should be fully funded, and pension promises that cannot be funded should be avoided.

The magnitude of underfunding of public employee pensions appears to exceed underfunding of private pensions. A substantial number of state and local government employee pension plans are underfunded. Federal pensions are also greatly underfunded. To maintain the solvency of underfunded plans, it will be necessary to increase taxes on future workers and/or cut benefits.

9. Pension funds should not be required to make investments to achieve social objectives other than the objective of protecting the economic security of the elderly.

Many state and local pension funds and even private funds are under pressure to invest in infrastructure and to make various other social investments. CED does not oppose arrangements that permit individuals to choose such investments, but we strongly oppose any mandated use of pension investment funds. Unless the individual chooses otherwise, pension investments should be based on sound economics (e.g., risk and return), not on social considerations.*

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*See memorandum by JAMES Q. RIORDAN, (page 82).

Chapter 2

Retirement Saving and Economic Security

In coming years, America will face the major challenge of providing for the economic security of its elderly population without placing unreasonable tax burdens on future generations. Retirement systems are already burdened by the rising life expectancy and a trend toward earlier retirement. More importantly, the United States, like many advanced industrial countries, will experience a very sharp rise in its retired population and the retiree-worker ratio when the baby-boom generation begins to retire.[1] Unlike citizens in many other countries, however, Americans are not setting aside resources adequate for their retirement needs. Indeed, overall saving rates in the United States have fallen to record low levels well below those of other industrial nations. Not only has the private saving rate declined precisely at a time when greater efforts should be made to prepare for the aging of the population, but the federal budget deficit is also absorbing the lion's share of those savings, thereby further reducing the amount available for investment needed to spur economic growth.

Saving for retirement must become a higher priority of individuals and government policy makers if future American retirees and taxpayers are to avoid unexpected hardships. But building adequate savings, like turning a large ship, is a slow process; it will take many years of higher saving to boost investment to the levels necessary to generate sufficient income to meet the expectations of future retirees. Thus, it is urgent that saving and retirement income policies be changed promptly. In this statement, CED argues that the reform of government tax and regulatory policies affecting private pension saving must play a critical role in this change.

THE ECONOMIC SECURITY OF FUTURE RETIREES

The retired elderly in the United States receive income from a variety of sources, (see "Sources of Funds for Retirement," page 17). The three primary components of the U.S. retirement system are: (1) the huge Social Security retirement program, which provides most retirees with benefits at least sufficient to meet their basic needs for subsistence; (2) the large and diverse private retirement system that grew rapidly with the encouragement of government tax incentives during the post–World War II period and now covers about 49 million workers;[2] and (3) the retirement programs sponsored by federal, state, and local governments for their own employees, which have grown in importance largely because of increasing employment in the state and local sectors.[3]

These three components, together with gains in personal wealth (especially investment in homes), have dramatically improved the well-being of present-day retirees relative to past generations of retirees. Some studies suggest that the overall economic welfare of today's younger retirees is comparable to that of present-day full-time workers. However, there are now serious concerns about whether the economic well-being of future retirees can be maintained at the level enjoyed by current retirees, let alone be improved, as many have

come to expect. The reasons for these concerns (discussed in detail in Chapter 3) can be summarized as follows:

- Individuals are living longer and retiring earlier. Greatly compounding this trend is the fact that the ratio of workers to retirees will decline sharply in the next several decades because of the retirement of the baby-boom generation. Consequently, the cost to each future active worker of supporting retiree benefits will rise sharply. Benefits financed on a pay-as-you-go basis may have to be cut back significantly in order to prevent taxes paid by future workers from becoming too burdensome.
- At present, saving for retirement is not sufficient in the United States to meet the income requirements of future retirees. This can be seen in the overall decline in contributions to retirement plans, the underfunding of many private and public plans, and record-low saving rates.
- There has been a gradual shift in coverage, especially among small employers, from employer-funded retirement plans to more discretionary saving vehicles such as 401(k) plans. The impact of this trend on the economic security of future retirees is not yet known with certainty.

Prompt changes in retirement policies can improve the prospects of future retirees. **To compensate for the rise in life expectancy, both business and government should encourage workers to take retirement at a later age. Policies should also be instituted that encourage saving and full funding of pension promises.** Recent changes in federal tax and regulatory policies governing private pensions have often moved policy in the wrong direction. (For a detailed discussion, see Chapter 5.) Changes in pension regulation have discouraged retirement saving and contributed to the underfunding of many pensions.

The American taxpayer has more than one reason to be concerned about the impact of insufficient saving for retirement. Future retirees who have inadequate incomes may demand increased retirement benefits from Social Security (or at least resist any cutback in benefits). Those with inadequate savings are more likely to become a burden on the government in other areas, such as long-term health care. Inadequate saving for retirement also affects the economic health of the nation more broadly.

THE ECONOMY AND RETIREMENT SAVING

Although this statement focuses primarily on the economic security of future retirees, we cannot overlook the adverse effect of pension policy on the economy and, in turn, the impact of a weakened economy on the well-being of future retirees. The decline in saving for retirement and other purposes has serious adverse implications for the future economic prosperity of the nation; a weak economy with little or no growth in productivity and real wages will, in turn, struggle to provide adequate support for rising numbers of retirees and to address other social problems. The Social Security Administration's underfunded liability for baby-boomer retirement benefits is a case of too many claims on too little output. One way to think about the impact of the burden of rising benefits for baby boomers is to ask: How much output will be left for workers? The implication of the Social Security Administration's intermediate projection is that nearly a quarter of the assumed 1.2 percent annual gain in labor productivity (real GDP per worker) between 2010 and 2030 will be absorbed by rising benefits paid by Social Security retirement, disability and hospital insurance benefits alone. However, the Social Security Administration's history of overoptimistic projections and the record-low national saving rates experienced in recent years raise the question of whether Social Security's productivity assumption is again too optimistic. If so, these programs will absorb an even

SOURCES OF FUNDS FOR RETIREMENT

There are six primary sources of retirement income, the funding of which will determine whether retirees' incomes meet expectations. To the degree that funding falls short, either retirees' entitlements and aspirations will have to be curtailed (by delay of retirement or by reduced living standards during retirement years), or the intergenerational transfer of purchasing power from the working generation to the retired generation must be increased, primarily through higher payroll taxes.

1. Social Security. About 90 percent of all workers participate in the Social Security system, whose role is to guarantee at least a minimum level of retirement income for every eligible retiree. This government program has greatly reduced poverty in America, although 12 percent of older people are still below the poverty level. In 1994, the median benefit for an individual was about $9,972. The maximum annual benefit for a couple is now $20,646.

2. Defined Benefit Plans. The largest accumulation of retirement funds is in defined benefit plans, which promise specific benefits and are typically sponsored by large employers. Approximately 15 percent of workers are enrolled in such plans, though there has been a tendency for small employers to discontinue the plans because of excessive regulatory burdens and costs. These plans, in combination with Social Security, generally replace about 60 percent of preretirement earnings for those who have worked at least thirty years. But workers who change jobs frequently or work part-time often fail to qualify or accumulate adequate vested benefits from these plans. (Those who do become vested may receive benefits from more than one plan.) Government workers are generally covered by defined benefit plans, many of which are underfunded and frequently have made overly generous promises.

3. Defined Contribution Plans. These plans promise no specific retirement benefit; instead, employers make specific contributions (often according to a formula related to income or profits) to an employee's retirement account. Such plans are often favored by smaller firms because they are less regulated and have lower administrative costs and more certain contribution requirements. An important advantage of defined contribution plans is that there is no public liability for inadequate funding. However, these plans often produce a lesser final benefit than a defined benefit plan. There are five times as many defined contribution plans in the United States as defined benefit plans, but many are small, and only about 26 percent of U.S. workers are currently active participants in a defined contribution plan that is their primary retirement plan.

4. Personal Savings. For retirees, the median cash income from assets was $2,356 in 1990. But personal saving has declined sharply in recent years, perhaps reflecting misinformation about the adequacy of provisions for retirement. The Social Security Administration will soon launch a program to provide workers with more information; this information, together with better information from employers, is necessary if workers are to understand the need for increased saving.

5. Postretirement Employment. For many, jobs (usually part-time) provide meaningful opportunities and often a necessary retirement supplement. About 22 percent of retirees had income from earnings in 1990. Under present Social Security rules, for those under 65 benefits are reduced by $1 for every $2 of annual earnings in excess of $8,040; and for those 65 to 69 years old benefits are reduced by $1 for every $3 of earnings in excess of $11,160. Social Security benefits are not reduced for workers who are 70 or older.

6. Private Intergenerational Transfers. The transfer of savings from deceased parents to children is an important source of income that for many could serve as a partial offset to shortfalls in their own retirement funding.

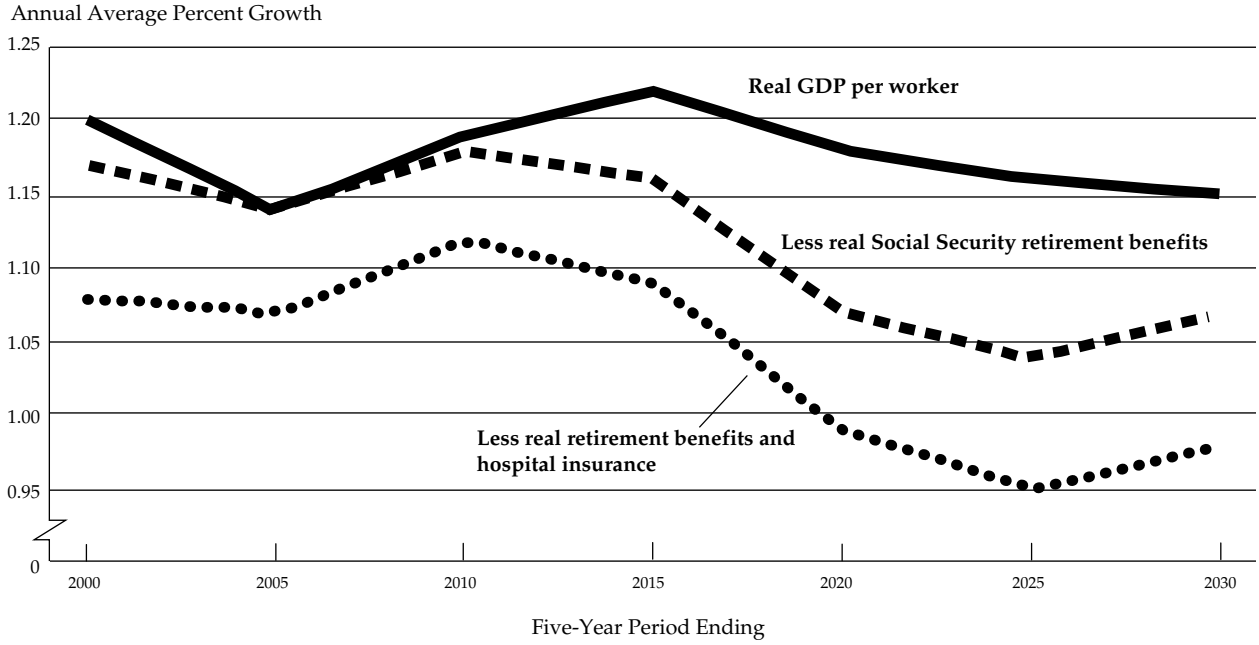
higher share of productivity gains. Moreover, when other transfers are taken into account, the gain in productivity available to active workers may decline sharply (see Figure 8).

Beginning in the mid-1970s, the growth in labor productivity in the United States slowed dramatically, from nearly 3 percent to about 1 percent a year, producing a long period of near stagnation of real wages. The prospects for restoring rapid productivity growth are largely dependent on increases in the rate of investment in physical and human capital and advances in technology. But increased saving is required to provide the funds for such investments, and unfortunately the nation has chosen to use a growing share of its income to finance current consumption rather than saving and investment. Indeed, the U.S. national saving rate — the sum of net saving by individuals, business, and government divided by GDP — has declined precipitously in recent years to record-low levels. Individuals, business, and government have all contributed to this decline. So far in this decade, net national saving has averaged less than 2 percent of GDP, down from 4 percent during the 1980s and about 8 percent in previous decades (see Figure 9). This decline in saving does not bode well for the future growth of the U.S. economy because national saving is the only source of domestic funds for investments that are needed to boost productivity. In fact, there is concern that the extremely low domestic saving rates experienced in recent years are not sufficient to prevent productivity growth from falling further.[4]

The national saving and investment rates in the United States have also fallen below those of most other advanced industrial nations (see Figure 10). This is bad news for the international competitiveness of the United States, which hinges on relative rates of productivity growth. Admittedly, investment rates in the United States have not been as

Figure 8

A Large Share of Worker Productivity Growth Will Go to the Elderly

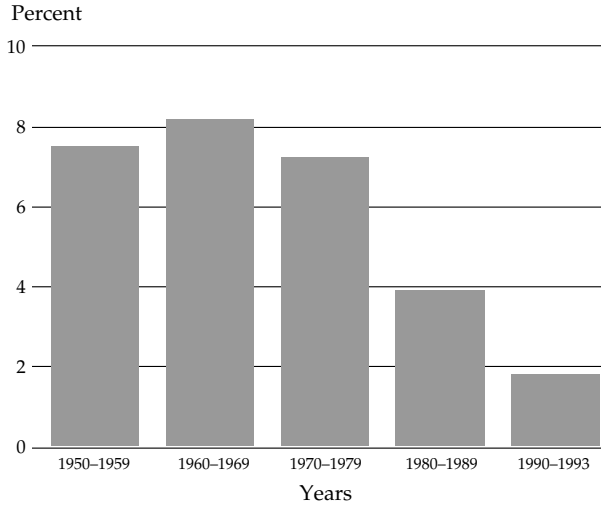


SOURCE: Tabulated from intermediate projections contained in the 1994 OASDI Trustees report.

Figure 9

U.S. National Saving, Selected Periods

(percent of GDP)



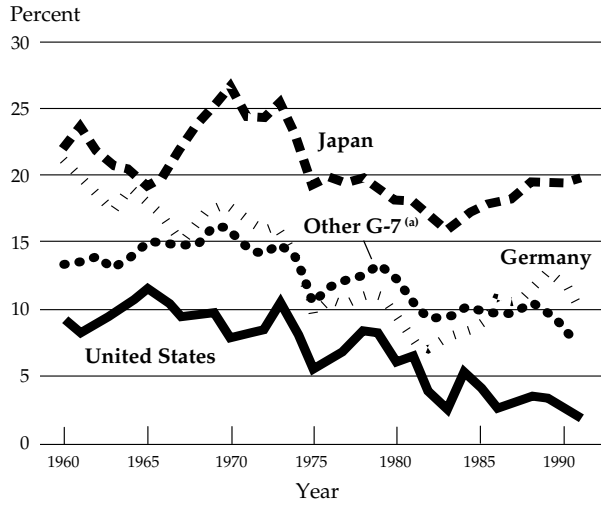
NOTE: National saving is net of depreciation.

SOURCE: Bureau of Economic Analysis.

Figure 10

National Saving in G-7 Countries, 1960 to 1991

(percent of GDP)



NOTE: National saving is net of depreciation.

(a) Other G-7 countries are France, Italy, Canada, and United Kingdom.

SOURCE: Organization for Economic Cooperation and Development.

weak as national saving rates because foreign capital inflows have financed a substantial amount of domestic spending for investment. But reliance on foreign capital inflows has serious disadvantages. These capital inflows increase foreign claims on future U.S. output, a particular concern when the inflows result from a decline in domestic saving rather than from rising investment opportunities in the United States. Foreign capital inflows have brought about a dramatic shift (now approaching $1 trillion) in the U.S. net foreign investment position. Once the largest creditor nation in the world, the United States has become the largest debtor, and the rising debt to foreigners represents a future burden for the nation.[5]

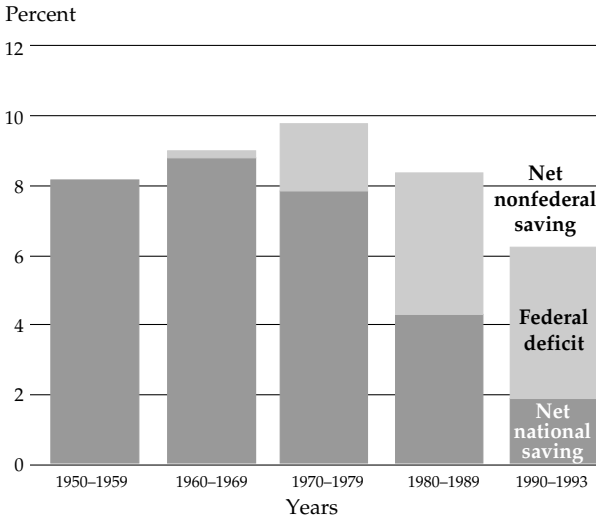
Why has saving fallen in the United States? Huge federal budget deficits made the largest contribution to the decline in net national saving (see Figure 11, page 20). In recent years, these deficits have absorbed about 70 percent of private savings. The private sector has also contributed to the decline. The corporate saving rate (retained earnings) declined sharply in the 1980s, though it now appears to be rising as profits recover. But the *personal saving* rate, which fell from about 8 percent of disposable income in the first half of the 1980s, remains very depressed at about 4 percent of disposable income.[6] *Retirement saving*, which is a very large (and growing) component of personal saving, declined from nearly 4 percent of disposable income in 1980 to less than 3 percent in recent years (see Figure 12, page 20). Clearly, any serious effort to increase private saving will require a change in current retirement policies.

In a 1992 policy statement, *Restoring Prosperity: Budget Choices for Economic Growth*, CED said that reversing the collapse in national saving should become an explicit goal of U.S. policy. It recommended that government policies should aim to restore the rate of national saving to the 8 percent norm that existed prior to the 1980s.[7] Two of the most potent policy instruments available for

Figure 11

Federal Deficits and National Saving, Selected Periods

(percent of net national product)



SOURCE: Bureau of Economic Analysis.

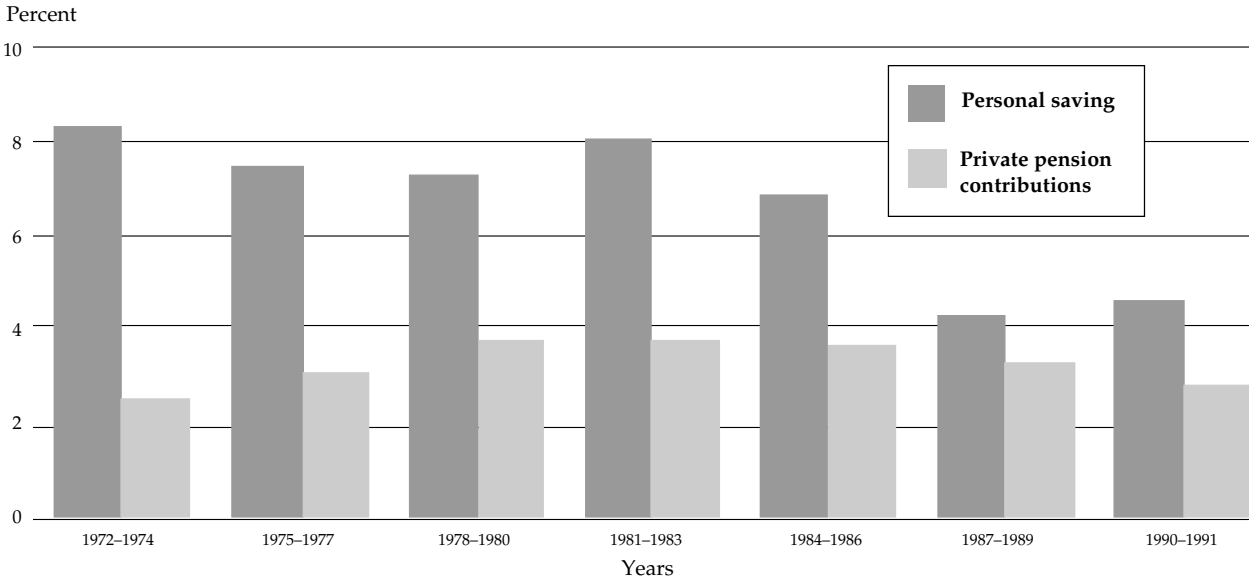
achieving that goal are federal budget policies to decrease the budget deficit and retirement policies to encourage private retirement saving.

With regard to the federal budget, CED recommended that the deficit be reduced by about $50 billion annually, with the eventual goal of achieving a surplus. From fiscal 1991 to 1993, the federal budget deficit averaged about $272 billion, or about 4.6 percent of GDP. The 1993 budget act and economic expansion have put the deficit on a lower path; it is expected to fall from 3.9 percent of GDP in fiscal 1993 to 2.3 percent of GDP in fiscal 1995.[8] This decline in the budget deficit will make a significant contribution to national saving, though policy makers have a long way to go to get entitlement spending under control and to achieve the target recommended by CED for the federal budget. Moreover, the long-term budget forecast is not so sanguine; later in the decade, the deficit is expected to begin rising

Figure 12

Personal and Pension Saving, Selected Periods

(percent of disposable personal income)



SOURCE: Bureau of Economic Analysis; pension saving series provided by staff at The Brookings Institution.

again as a percent of GDP.[9] **CED continues to recommend implementation of policies that will gradually move the federal budget toward balance as a means of increasing national saving and investment.**

With respect to retirement policies, it is clear that measures that succeed in increasing private retirement saving by expanding pension coverage and increasing contributions of current participants have the potential for substantially increasing household saving. However, it may be very difficult to restore pension saving rates to earlier levels. Changing individual priorities would be critical because many individuals are not saving anything for their own retirement.[10] Some of the blame for the decline in retirement saving must be attributed to ill-advised changes in public policies that discourage business contributions to pensions. (We examine this issue in detail in Chapter 5.) These policies should be reversed.[11] It should also be noted that the public sector has contributed more directly to the problem of inadequate saving by underfunding both public employee retirement programs and Social Security retirement promises (see Chapter 3).

The recent weakness in private pension saving is an important component of the national saving and investment problem. **Clearly, the United States needs to employ pension policies to encourage saving not only to improve the economic security of individual retirees but also to boost national economic growth and competitiveness.** More rapid growth of the economy, in turn, will make it easier for this country to support its rising elderly population.

PRIVATE- AND PUBLIC-SECTOR RESPONSIBILITIES FOR PENSIONS

We have seen that both the nation and individual citizens have a strong interest in retirement savings accumulated for the baby-boom generation. But precisely whose responsibility is it to provide for their pensions? Observers report that some present-day workers have the mistaken belief that government and business will provide for all their retirement needs. Such beliefs may arise because workers do not have adequate information about the benefits they will be entitled to in retirement.

Although CED believes that each family should take *primary* responsibility for its own economic welfare, we agree that all sectors of society, including business, have a stake in a healthy private pension system and in the welfare of retirees. We believe that a reasonable arrangement would have Social Security and voluntary business-sponsored pensions providing a reasonable minimum level of retirement income for workers, with the individual being responsible for improvements beyond that minimum. Given pension arrangements already in place, including the Social Security system, the following division of responsibilities is recommended:

- **Social Security should provide a minimum level of retirement income for all working members of society and their dependents.**
- **Business, nonprofit employers, and governments should be encouraged to provide supplemental retirement assistance. Employers often provide retirement benefits to attract and retain competent workers. The combination of Social Security and employer-sponsored plans is generally intended to provide retirees with a reasonable minimum standard of living, though with less income than that received by active workers.**
- **Individual workers should have ultimate responsibility for achieving retirement income above that provided by Social Security and employer retirement plans, according to their desired standard of living.**

ACTIONS REQUIRED TO MEET THESE RESPONSIBILITIES

It is important that each group — government, private employers, and individuals — meet their responsibilities without placing an unfair burden on future generations. **As a practical matter, this means that retirement savings must be sufficient to fund promised benefits and the average retirement age must be raised to reflect longer life spans. CED urges both business and government to review retirement programs to ensure that they do not provide ongoing disincentives for productive employment by the elderly, without reducing the ability of firms to restructure as needed.**

Social Security. With respect to programs financed largely on a pay-as-you-go basis, such as Social Security, government must be careful to resist pressures to promise generous unfunded retirement benefits beyond those necessary to provide a basic floor of retirement income. Thus far, our political leaders have not been willing to face the demographic challenge and the long-term underfunding of promised Social Security benefits. Longer retirement spans have greatly increased the cost of retirement benefits since the inception of Social Security, and the Social Security Administration's long-term projections indicate that the system's assets will be depleted rapidly when the baby-boom generation retires unless benefits are cut and/or payroll taxes are increased sharply (see Chapter 3). An increase in the normal retirement age from 65 to 67 years is scheduled to be phased in during the years 2003 through 2025, but this increase does not fully compensate for the increase in life expectancy.[12] At the same time, earnings limitations applied to those receiving Social Security benefits have reduced the supply of productive workers and exacerbated the decline in the worker/retiree ratio.[13]

Because the primary concern of this policy statement is private retirement saving, we do not investigate the merits of alternative proposals for "fixing" Social Security. However, as a matter of equity and sound fiscal policy, **CED has long favored the taxation of *all* Social Security benefits that exceed past contributions.** This change would be a form of means test that would also improve equity in taxation by treating income of workers and retirees in the same way.[14] **CED also recommends that Congress consider other limitations on Social Security benefits, such as an increase in the normal and early retirement ages beyond that already legislated, reduced cost-of-living adjustments for benefits above a basic floor, and a gradual phase-in of lower replacement ratios (i.e., the ratio of retirement benefit to income received during years of employment). To reduce the disincentive for the elderly to continue to work, the limit on earnings of recipients of Social Security benefits should be raised substantially. Such changes could place the Social Security program on a sound footing and avoid an unfair burden on future generations.**

Private employers. Fully funded private and public employee retirement programs are critical for many retirees and also have great social value, because they add to national saving. **We believe all employers should be encouraged to provide retirement plans or at least to give employees the opportunity to accumulate retirement savings with tax-sheltered contributions from their own incomes.** Public and private employers have an obligation to adequately fund the pension promises they make to their workers and to maintain high standards of fund management. Individuals are also more likely to achieve their retirement-saving objectives if retirement benefits can be preserved when a worker moves from one employer to another. **CED believes that employers should place a high priority on improving vesting and the portability of retirement assets.**

Individual responsibility and the education of workers. Individuals, on the other hand, can tailor their retirement-saving decisions to their particular circumstances. When deciding on an income-replacement ratio that meets their

needs, individuals would, in theory, have the option of choosing the age at which they will retire, whether they will continue to work after retirement, and the rate at which they will draw from existing assets, including equity in a home. However, in a world where job security is uncertain, workers may not always have such employment choices, and many workers will have few assets other than pensions. Most workers will need to set aside substantial savings in addition to pensions to achieve their lifestyle expectations.

However, American workers are not well informed about retirement saving and, indeed, about personal finance.[15] To prepare intelligently for their retirement, individual workers require *information* about prospective benefits from Social Security and private pensions. In those instances in which workers have some control over the amounts they elect to contribute to pension plans and the distribution of those contributions over different kinds of investments, they also need information on how their choices could affect their retirement income. Unfortunately, workers frequently do not have such information, though it may be readily available (see Chapter 3) and can be provided at low cost. There is also evidence that Americans have a poor level of financial literacy and that this deficiency is a strong factor in poor saving decisions.[16] **CED believes that business and government have the additional responsibility of providing workers with adequate and realistic information about their pensions, including retirement needs, accumulated benefits, and the funding status of their plan. We also believe that the Department of Labor should provide guidance designed to encourage employers to provide information on retirement saving and investment to their employees and to protect plan sponsors against unreasonable lawsuits. For example, information provided by employers about *past* market performance should not make employers legally liable if *future* performance is inconsistent with experience.** Given the long-term funding problems of Social Security, it is important to inform workers that circumstances may necessitate the enactment of measures that reduce the growth of future benefits.

Employer-provided pension benefits are future payments for current work: that is, deferred compensation. As such, pension benefits, like wages generally, are primarily a private-sector issue. However, the U.S. experience with some private pensions before the enactment of ERISA suggests that government also has a responsibility to provide reasonable and stable regulation of private pensions in order to make sure that pensions meet appropriate fiduciary standards and that pension promises are kept. The contribution of private pensions to the economic security of retirees and to the strength of the national economy indicates that the private pension system has an important social value that extends beyond the specific benefit to individual retirees. **In CED's view, the social benefits of private pensions justify some government oversight (provided that it is responsible, low cost, and stable) and appropriate tax preferences to encourage retirement saving.** (These issues are discussed in detail in Chapters 4 and 5.)

Chapter 3

The Basic Facts on Our Aging Population and Retirement Saving

AN AGING POPULATION

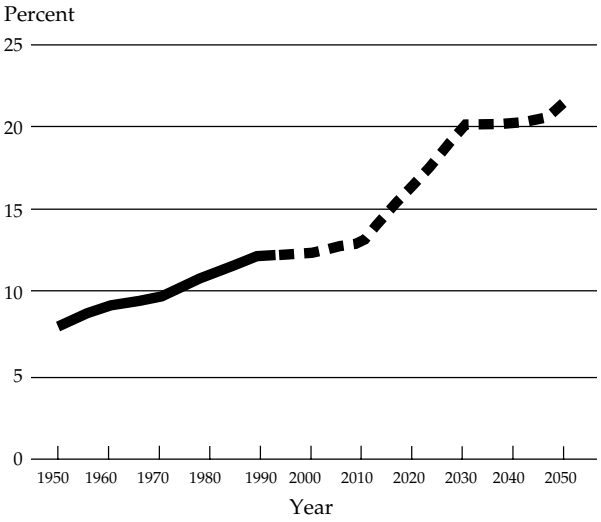
One of the most significant social developments in the United States during the twentieth century has been the phenomenal growth of the elderly population. During the first ninety years of this century, the number of people age 65 years or older in the United States rose by nearly 29 million, from 4.6 percent of the total population to 12.3 percent. This rapid growth reflected the combined influence of three factors: (1) a spectacular increase in life expectancy (from 47 years in 1900 to 75 years in 1990), (2) a sharp decline in the birthrate, and (3) a reduction in immigration.

All these factors may contribute to the relative growth of the elderly population in the future, though the precise contribution of each is uncertain. However, the future growth of the retired population will also be greatly influenced by an additional factor about which there is no doubt: The *baby-boom generation* will begin to reach retirement age in about a decade. This group, which includes about 76 million individuals born between 1946 and 1964, comprises an unusually large segment of the U.S. population because the birthrate rose during that period and declined thereafter. Because of the baby-boom bulge in the age distribution, the growth of the elderly population during the first half of the twenty-first century is expected to accelerate (see Figure 13), substantially exceeding the very rapid growth in this century. The Social Security Administration's intermediate projection indicates that the proportion of the population age 65 and older will rise from about 12 percent currently to about 20 percent by 2030, when aged persons will number more than 68 million. The number of beneficiaries of the Social Security retirement and disability program (OASDI) is projected to rise from 41.8 million in 1993 to 80.3 million in 2030.[1]

The social implications of such an acceleration in the growth of the aged population are quite profound. Even with a gradual increase in the elderly population, the growth in government spending for the elderly has been phenomenal. In the last three decades, spending for Social Security, Medicare, and other related retirement and disability programs rose

Figure 13

Percentage of U.S. Population Age 65 and Over, 1950 to 2050



SOURCE: Social Security Administration (intermediate projection)

from 16.5 percent to 36.5 percent of total federal expenditures. In 1993, 55.5 percent of total federal expenditures for purposes other than defense and interest on the national debt went to the elderly. If government programs for the elderly are not changed, the retirement of the baby boomers will cause the cost of these programs to rise to unsustainable levels.

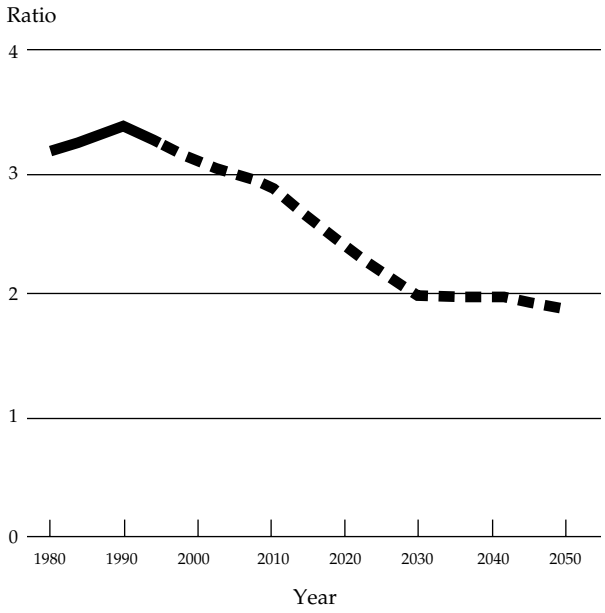
The potential burden on workers to support Social Security retirement benefits can be seen by examining the ratio of workers to retirees. This ratio has remained fairly stable since 1975 in a range of 3.2 to 3.4; but with the retirement of the baby boomers it will decline sharply. The Social Security Administration's intermediate projection shows the ratio of *covered* workers (those who have earnings creditable for Social Security benefits) to beneficiaries declining from 3.4 in 1990 to 2.0 in 2030 and below 2.0 by midcentury (see Figure 14). This projection is based on highly uncertain assumptions about immigration, fertility, and death rates that some believe are unrealistic. Under the Social Security Administration's more pessimistic assumptions, the ratio of covered workers to beneficiaries would fall to 1.5 by 2050.[2] Obviously, the financing of promised Social Security retirement and disability benefits on a pay-as-you-go basis would require a large increase in the payroll tax burden falling on future workers and employers. The current intermediate projection suggests that the tax increase from 1994 to 2030 for promised retirement benefits (OASDI) alone would probably be in the range of 3 to 7 percentage points, depending on how long the increase is delayed and a number of other unknown factors.[3] Furthermore, any such increase in payroll taxes would be in addition to tax increases to finance the rising cost of health care for the aged, whether through Medicare or other public or private programs.

Of course, the ratio of covered workers to beneficiaries by itself does not present a complete picture of the overall economic burden on future workers. The total dependency ratio, which takes into account the number of young people as well as the number of elderly, is not expected to rise as much as the aged dependency ratio (see Table 1, page 26).[4] However, the total dependency ratio substantially understates the burden on workers because the cost of supporting the elderly greatly exceeds the cost of supporting the young, particularly when health care costs are included,[5] and because the dependency ratio does not take into account the fact that many workers retire before the age of 65. Therefore, the projected decline in the ratio of covered workers to beneficiaries represents a reasonable measure of the likely impact of the coming demographic changes on workers and employers.

It is often asserted that policy makers could exert a mitigating effect on these demographic trends by carefully controlling immigration

Figure 14

Ratio of Workers to Social Security Recipients, 1980 to 2050



NOTE: Workers are defined here as persons having earnings creditable for Social Security.

SOURCE: Office of the Actuary, Social Security Administration.

Table 1

Dependency Ratios

Year	Aged[a]	Total[b]
1990	0.209	0.700
2000	0.210	0.691
2010	0.216	0.652
2020	0.279	0.701
2030	0.360	0.791

(a) Population 65 and over divided by population age 20–64.
(b) Population 65 and over plus population under age 20 divided by population age 20–64.

SOURCE: Board of Trustees. Federal Old Age and Survivors Insurance and Disability Trust Fund, *1994 Annual Report* (Washington, D.C.: U.S. Government Printing Office, 1994), p. 144.

so as to boost the number of young workers and reduce the decline in the ratio of covered workers to retirees. But given the magnitude of the shortfall in workers, it is not likely that immigration could make a significant dent in the problem. The number of additional workers required to stabilize the ratio at its 1990 level (3.4) is about 13 million in the year 2000 (see Table 2). The shortfall would rise to 110 million by 2030 and 128 million in 2050, about 36 percent of the projected population in that year. The number of additional immigrants necessary to offset this shortfall of workers would be much larger than these figures because many of the immigrants would be retired by 2030.[6] (The baseline projection already includes an assumption that about 8.5 million immigrants, about 4 percent of whom will already be over the age of 65, come to the

Table 2

Number of Workers Required to Hold the Worker-Beneficiary Ratio at Its 1990 Value of 3.4 to 1 (millions)

	Social Security Projection				Number of Workers Needed to Hold Worker/Beneficiary Ratio to 1990 Level	
	Baseline Population Projection	Social Security Beneficiaries	Workers	Ratio of Workers to Beneficiaries	Additional Workers	Percent of Projected Baseline Pop.
1990	259	39	133	3.4	0	0%
2000	285	47	147	3.1	13	5
2010	306	55	157	2.9	28	9
2020	325	68	161	2.4	70	22
2030	340	80	163	2.0	110	32
2040	349	84	166	2.0	121	35
2050	354	87	168	1.9	128	36

NOTE: Workers refers to covered workers.

SOURCE: Social Security Administration intermediate projection.

United States between 1990 and 2000.) Recent research indicates that massive immigration would be required to have any significant effect.[7]

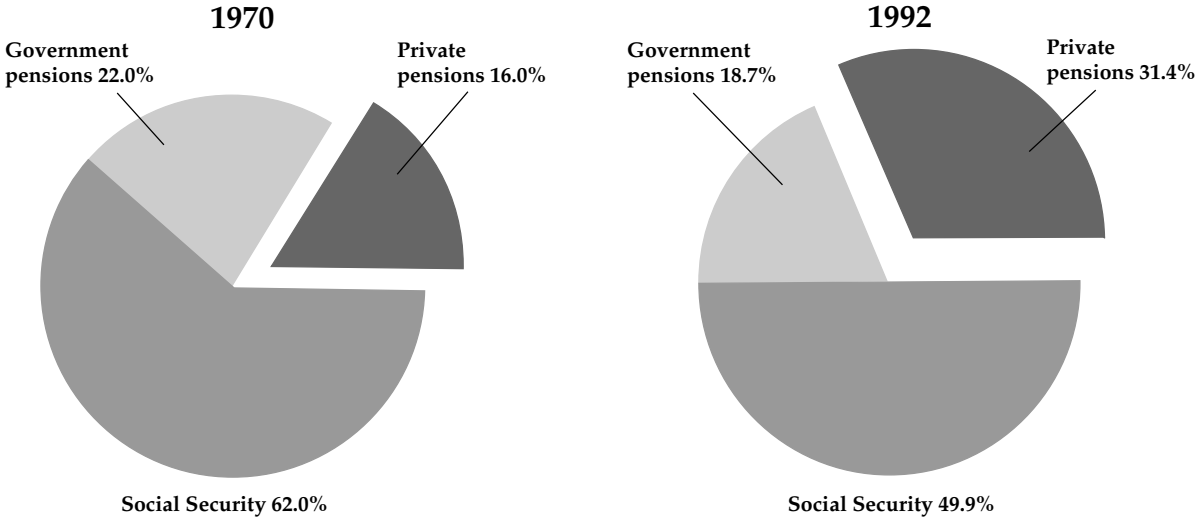
The coming bulge in the elderly population is the inevitable consequence of the aging of the baby boomers. No reasonable public policy would change these demographic trends sufficiently to halt the decline in the ratio of workers to retirees. From this circumstance, we conclude that it is critically important to increase retirement saving in anticipation of the rise in the aged population.

PRIVATE SECTOR PREPARATION FOR RETIREMENT OF THE BABY BOOMERS

Total retirement income from all sources, including Social Security and private pensions, now exceeds half a trillion dollars annually in the United States, roughly 10 percent of personal income. In 1992, Social Security accounted for half of total retirement payments; government pensions and private pensions accounted for about 19 and 31 percent, respectively (see Figure 15). Total private pension payments grew very rapidly until the mid-1980s. Consequently, the Social Security retirement share of benefit payments declined (from 62.1 percent in 1970 to 48.1 percent in 1986); since the mid-1980s, it has remained about the same. For most individual retirees, Social Security is the most important source of income; benefits were received by about 92 percent of the aged in 1992. In that year, about 66 percent of the elderly had income from assets, and 44 percent received retirement benefits other than Social Security. About 29 percent of private sector retirees receive a private pension. In 1994, the median annual Social Security payment was $9,972, which was roughly 80 percent higher than the median private pension annuity payment, and 3 times the median cash income from assets. For retirees who receive private pensions after thirty years of service from medium-size and large private establishments, the combined

Figure 15

Retirement Benefit Payments, by Source, 1970 and 1992
(percent of total payments)



SOURCE: Employee Benefit Research Institute.

private pension and primary Social Security benefit replaced 59 percent of wages in 1990. Figures 15 (see page 27) and 16 show retirement income from all sources, including government.[8]

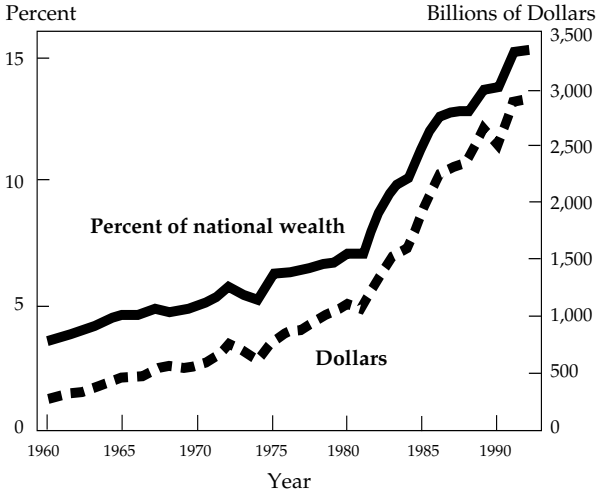
PRIVATE PENSION CONTRIBUTIONS

In recent decades, private pension assets in the United States have grown rapidly in dollar terms and as a share of national wealth (see Figure 17). However, much of the increase reflects an appreciation in the market value of these assets rather than saving out of current income.[9] This is seen in Figure 18, which shows that total contributions to private pensions in real terms have declined during the last decade despite the rapid growth of the labor force. Real contributions per worker have fallen sharply.

New funding limits enacted in the 1980s (see Chapter 5), together with a rise in asset values, caused the employer component of

Figure 17

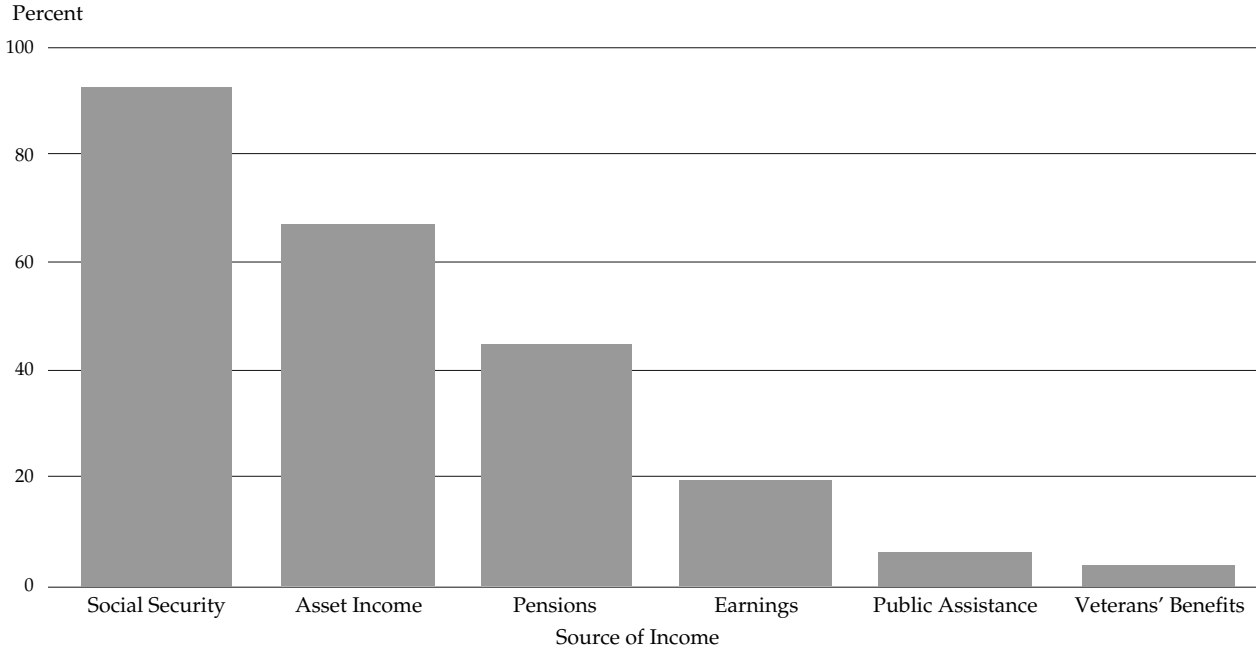
Private Pension Assets, 1960 to 1992
(in 1992 dollars and as a percent of national wealth)



SOURCE: Pension and Welfare Benefits Administration, Employee Benefit Research Institute, and Federal Reserve.

Figure 16

Percentage of the Aged with Income from Various Sources, 1992



SOURCE: Office of Research and Statistics, Social Security Administration.

pension contributions to decline. As shown in Figure 19, total employer contributions per worker fell sharply in real terms. The change in funding limits forced many firms to halt or delay contributions in recent years, a particularly unfortunate development from a national saving perspective. Such required reductions in contributions, especially when triggered by short-term increases in interest rates, are also very shortsighted (for an explanation, see "Estimating Liabilities and Funding for Defined Benefit Plans," pages 52 and 53); if there is a reversal of these rates, many companies would quickly find that they need to make extremely large contributions so that their pensions will not become underfunded.[10] A situation that requires very large future contributions may discourage growth in pension coverage.

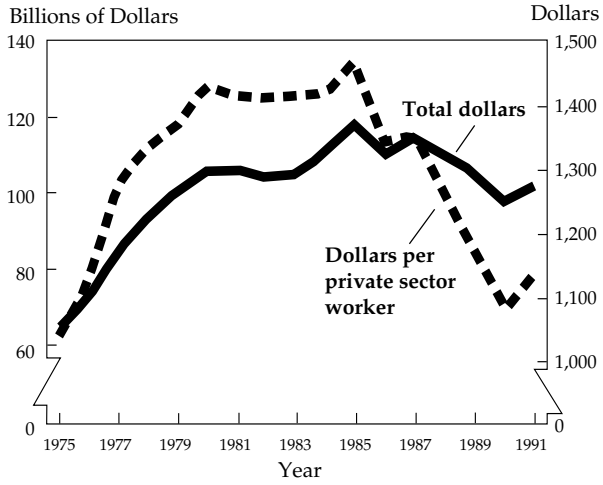
PRIVATE PENSION COVERAGE[11]

Private pension coverage rose sharply in the early postwar period. By 1970, about 52 percent of full-time private-sector workers were covered by some type of private pension, and coverage has become almost universal for the largest employers. However, total pension coverage has not increased significantly since the early 1970s. But although overall pension coverage appears to have stabilized, coverage for male workers has declined, and participation of younger workers in pension plans is significantly lower than that of middle-aged and older workers (see Figure 20, page 30).[12]

Despite the weakness in private pension contributions and coverage, the proportion of households that will receive a pension may rise because of shorter vesting times and the increased participation of women in the labor force. On average, however, women's pensions are significantly smaller than men's because they have had shorter working lives and lower earnings. Moreover, higher-income households are still much more likely to have private pension coverage of some type than lower-income households, even though nondiscrimination rules were intended to broaden the coverage provided by individual pension plans. In 1993, nearly 80 percent of workers

Figure 18

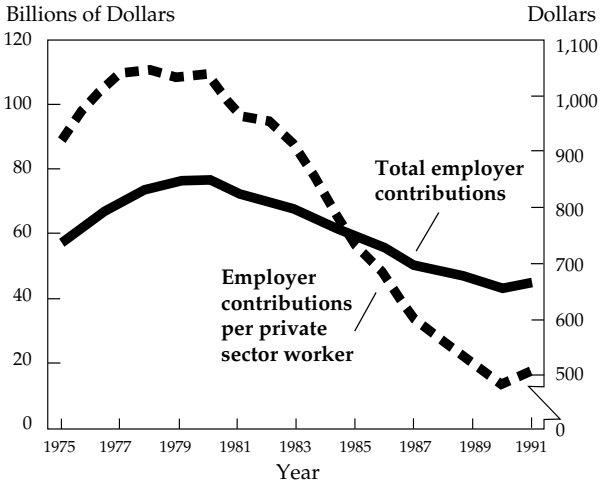
Total Contributions to Private Pension Plans, 1975 to 1991
(in 1987 dollars)



SOURCE: Brookings Institution.

Figure 19

Employer Contributions to Private Pension Plans, 1975 to 1991
(in 1987 dollars)



SOURCE: National income and product accounts.

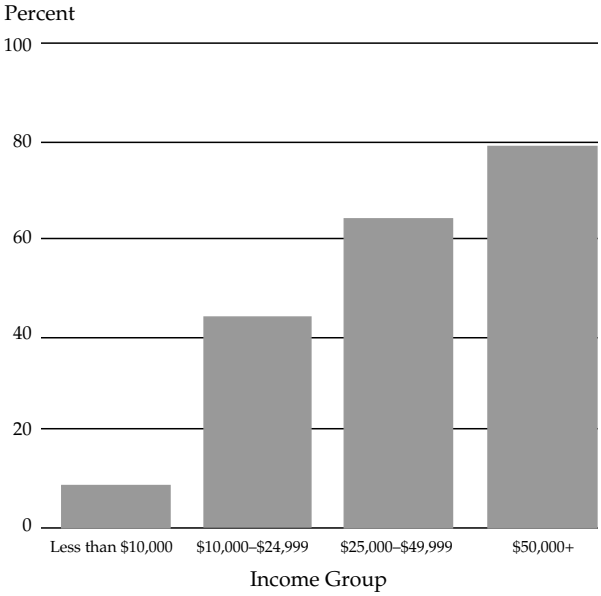
with annual incomes of $50,000 or more participated in a pension plan, whereas only about 9 percent of those with incomes of $10,000 or less participated (see Figure 21).

DECLINE IN DEFINED BENEFIT PLANS

The type of pension coverage available to workers is undergoing a dramatic shift. There has been a sharp decline in the private sector in the number of defined benefit plans.[13] These plans, which provide specified retirement benefits, are the type of pension most often provided by older and larger companies. In contrast, the number of defined contribution plans, particularly 401(k) plans, has grown rapidly, thereby preventing a drop in total coverage (see Figure 22). But the assets of defined contribution plans are still only 40 percent of total pension assets (see Figure 23). This is because defined contribution pension plans are most frequently used as primary pensions by small firms, the self-employed, and individuals, and as supplementary (frequently voluntary) pen-

Figure 21

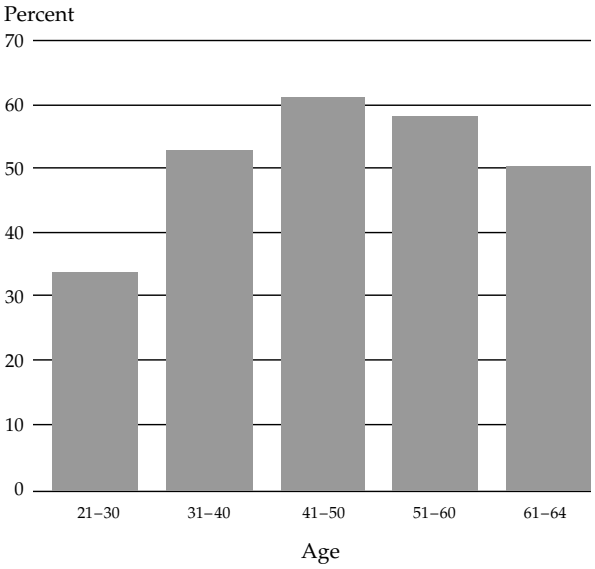
Pension Participation, by Income Group, 1993



SOURCE: Employee Benefit Research Institute.

Figure 20

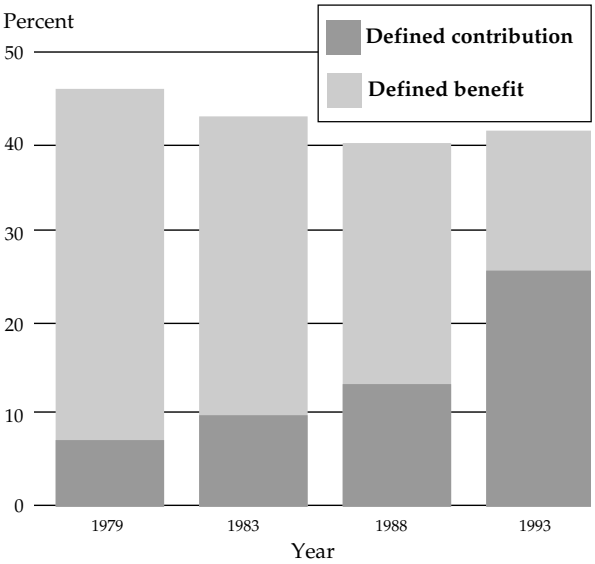
Pension Participation, by Age Group, 1993
(percent of workforce)



SOURCE: Employee Benefit Research Institute.

Figure 22

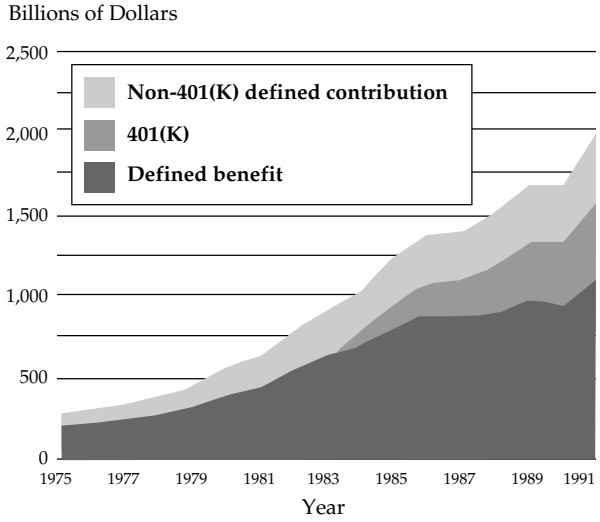
Private Pension Plan Participation, by Type of Plan, 1979 to 1993



SOURCE: Adapted from Department of Labor and Employee Benefit Research Institute tabulations of *Current Population Survey* data.

Figure 23

Private Pension Plan Assets, by Type of Plan, 1975 to 1991

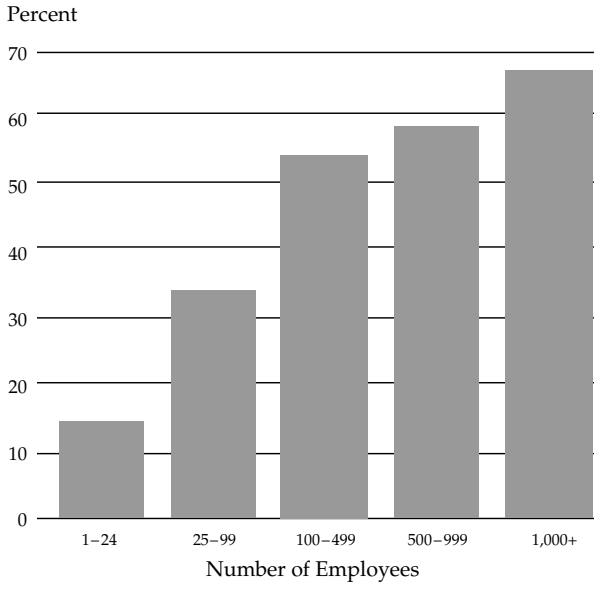


NOTE: Funds held by life insurers under allocated insurance contracts are excluded.

SOURCE: Department of Labor.

Figure 24

Pension Plan Participation, by Size of Firm, 1993



SOURCE: Employee Benefit Research Institute.

sion saving by firms whose primary retirement program is a defined benefit plan. Employees of large firms are still much more likely to be covered by a pension than employees of small firms (see Figure 24). Many smaller firms do not offer their employees a pension plan. Evidently, economic factors such as the uncertainty of future income have much to do with this. Smaller firms also tend to have a greater percentage of employees who are young, part-time, and/or not likely to stay in their job for a long period.[14] Formation of new plans has declined in recent years, and most of the pensions that have been introduced by small firms are of the defined contribution type.[15]

The decline in defined benefit plans, which is at least partly the result of government regulations (see Chapter 5), has also raised fears about the economic security of future retirees. Critics of defined contribution plans believe that these plans will not provide retirees with adequate income. This is not a settled issue, and some researchers have reached the conclusion that defined contribution plans actually provide greater economic security, in part because of their portability.[16] But it is possible to improve vesting and portability of defined benefit plans. As we noted in Chapter 2, **CED regards improved portability of pension assets as a worthy objective and urges regulators to investigate the various options for achieving this goal.**

PRERETIREMENT WITHDRAWALS OF PENSION FUNDS

Pension contributions and coverage rates do not tell the whole story about the adequacy of ongoing preparations for the retirement of the baby-boom generation. Many plans (including both defined benefit and defined contribution plans) permit borrowing from pension assets and lump-sum distributions at retirement or when changing jobs. The increasing number of preretirement distributions received when changing jobs appears to be a serious threat to retirement saving. Although the tax code strongly encourages the rollover of

lump-sum distributions into IRAs or other qualified retirement instruments, one survey suggests that only a small fraction of recipients do so; 40 percent of recipients use some of the funds for consumption.[17] Preretirement lump-sum distributions *not* rolled over amounted to about $42 billion in 1990.[18]

Many observers have become concerned that lump-sum withdrawals and borrowing from pension assets, which are now quite common, will undermine saving for pensions and the adequacy of retirement income. On the other hand, a substantial proportion of funds not invested in qualified instruments is placed in other forms of investment, such as housing and education, and these investments may improve living standards in retirement. Although the net impact on the well-being of future retirees of preretirement lump-sum withdrawals and borrowing from pension funds is not certain, there certainly appears to be a risk that such practices will undermine the adequacy of future retirement income. Moreover, the depletion of retirement funds may ultimately put pressure on policy makers to raise Social Security benefits. (CED's recommendations pertaining to preretirement withdrawal of pension assets are described in Chapter 5).

THE STATUS OF PENSION FUNDS

PRIVATE PENSION FUNDS

There is also evidence of inadequate pension saving in the deterioration of pension funding for some defined benefit plans. This deterioration jeopardizes not only the economic security of future retirees but also the future financial strength of the economy and the employers that have promised pensions. Pensions are a major source of national saving and capital for productive investment. Pension plans own about one-fourth of all corporate equities and one-third of the fixed obligations of business; and of course, pensions are a major holder of government obligations.[19]

Federal regulatory and tax policies pertaining to funding have been schizophrenic. They require minimum-funding levels to protect benefit promises but limit maximum funding so stringently that the health of even well-funded plans is threatened. Ironically, the maximum-funding requirements, which were enacted to limit federal revenue losses, actually heighten the exposure of taxpayers to the possibility of increased Treasury expenditures to bail out the Pension Benefit Guaranty Corporation (PBGC), the federal government agency that insures defined benefit plans.[20]

The PBGC guarantees that a specific portion of the promised benefit will be paid regardless of the financial condition of the sponsor. Because of termination of underfunded plans, the PBGC has taken over plans with billions of dollars of promised benefits. The PBGC's financial condition has raised questions about its viability and the security of pensions it guarantees, and this has led to proposals for reform. (Further discussion of the operation of the PBGC is provided in Chapter 5.)

The 66,000 defined benefit plans insured by the PBGC have promised about $900 billion in benefits. The PBGC believes that most of these pensions are well funded, but it notes a continuing deterioration in coverage and funding. According to the PBGC, *overfunding* has declined, and there has been a substantial rise in underfunding. The decline in funding status reflects the combined effects of falling interest rates (which increase the present value of plan liabilities) and funding limits enacted by Congress in 1987 in an attempt to raise federal revenues.

The total underfunding of all plans insured by the PBGC amounted to $71 billion at the end of 1993, an increase of $18 billion from the previous year. A relatively small number of firms account for a large share of the underfunding; in 1993, just fifty companies accounted for 56 percent of the underfunding in single-employer plans. The typical under-

funded plans, according to the PBGC, are "collectively-bargained flat benefit plans that do not anticipate future salary and wage increases in their funding operations."[21] Many believe that the PBGC figures understate the funding problem because of the measures of funding adequacy that the PBGC is required to use.[22]

PUBLIC SECTOR FUNDING OF PENSIONS

The primary concern of this statement is private retirement policies. However, a discussion of the status of retirement saving would not be complete without some mention of the underfunding of pensions sponsored by government, which is a very serious problem.

Social Security Funding.[23] The Social Security retirement system was designed to be a universal retirement program that provides a basic retirement income through a transfer from workers to retirees, including some redistribution to lower-income retirees, financed largely on a pay-as-you-go basis by payroll taxes. In effect, it is a compact between generations whereby current workers agree to support retirees in return for similar consideration in their retirement from future workers. Social Security is the most important source of income for the elderly and is received by 92 percent of retirees. The maximum annual retirement benefit for a worker who retired at age 65 in 1994 was $13,797. It is estimated that the average worker qualified for about $9,972, which replaced about 43 percent of earnings. Recent budget legislation raised the tax on Social Security benefits received by higher-income retirees (see Chapter 2).

Social Security is particularly important for low-income retirees because it replaces a higher share of their income. In 1994, the replacement ratio (Social Security benefits as a share of preretirement income) averaged about 58 percent for workers whose income was below average, compared with 24 percent or less for higher-income workers. Social Security is credited with having sharply reduced poverty among the elderly and, together with Medicare and private pensions, with boosting the income of many retirees nearly to the level enjoyed by workers (see "The Economic Status of the Elderly and Nonelderly Compared," page 34).

Because they had paid so little in taxes, the early recipients of Social Security retirement benefits received a very high return on their contributions. In fact, for almost all individuals who currently receive benefits, the annuity value of their benefits exceeds their contributions paid (plus interest). The return on contributions is generally higher for low-income recipients, though in absolute terms the excess of benefits over contributions has generally favored higher-income recipients. However, the return for all new retirees is falling rapidly and will become negative for higher-income single individuals (particularly men) later in this decade. Single individuals retiring early in the next century face deeply negative returns.[24] This situation has led many to question the long-term political viability of the Social Security program if reform is not forthcoming.

Social Security retirement and disability benefits are financed primarily on a pay-as-you-go basis. At present, a 6.2 percent payroll tax is paid by both employers and employees (a total of 12.4 percent) on earnings up to $60,000.[25] The system currently has a temporary positive cash flow. However, long-term projections of program expenditures and revenues show that *on a net-present-value basis*, Social Security is massively underfunded. At present, receipts in excess of benefit payments and other expenses accumulate in the OASDI trust fund, which had an estimated balance of $427 billion at the end of 1994, about 130 percent of one year's expenditures.

One of the problems with a retirement system financed on a pay-as-you-go basis is that the tax burden on workers increases as the

ratio of retirees to workers increases. This effect can be minimized by building trust fund balances that are later spent down during a bulge in the retirement-age population. The 1983 Social Security Amendments raised payroll tax rates not only to ensure the current solvency of Social Security retirement funds but also to prefund the bulge in benefit payments that will be required by the retirement of the baby-boom generation. The amendments also reduced benefits for future retirees by gradually raising the age requirement for full retirement benefits from 65 to 67 years. These changes were projected to generate a large annual positive cash flow that would boost the OASDI trust funds to nearly $21 trillion by 2045. The 1983 projections indicated that if tax rates and benefits were not changed, the trust fund would maintain a positive balance until 2063 (under intermediate assump-

THE ECONOMIC STATUS OF THE ELDERLY AND NONELDERLY COMPARED

The *income* of the elderly has clearly grown more rapidly than the income of the nonelderly in the postwar period. Nevertheless, it is not easy to develop meaningful comparisons of the current economic status of the elderly and nonelderly. On a before-tax cash income basis, the median family unit income of the elderly was about 70 percent of all nonelderly in 1990 and about 50 percent of the income of 45- to 55-year-olds, the age group with the highest earnings. But such figures may give a misleading picture of the economic status of the elderly.[a] To begin with, the distribution of incomes of the elderly appears to be quite variable; the more senior elderly, for example, generally have much lower incomes than younger elderly. However, compared with the nonelderly, the elderly often face lower tax rates, have more wealth, and receive significantly more noncash income. Indeed, some studies have found that the real median income of the elderly is comparable to the median income for all nonelderly if such factors are taken into account.[b] Such findings are controversial, in part, because the value of Medicare and other noncash income is difficult to determine.

Poverty rates among the elderly have declined sharply; government tabulations show a decline from 27.9 percent in 1967 to 12.2 percent in 1990.[c] In 1990, the poverty rate for the elderly would have been 36 percent higher if no Social Security benefits had been received.[d]

It has been widely reported that by 1990, the poverty rate for the elderly was actually below the rate for *all* nonelderly (13.7 percent). However, the overall nonelderly rate was boosted by very high poverty rates for children. Poverty rates for the elderly are still above the poverty rates for nonelderly adults. Moreover, these poverty measures do not take into consideration wealth and other factors that influence economic well-being. Compared with younger people, for example, the elderly face a much greater risk that their economic status will be adversely affected by large medical bills.

a. For income data by age group, see Daniel B. Radner, *An Assessment of the Economic Status of the Aged* (Washington, D.C.: Social Security Administration, Office of Research and Statistics, May 1993), p. 32.

b. Michael D. Hurd, "The Adequacy of Retirement Resources and the Role of Pensions" (October 1993). Hurd adjusted cash incomes for such things as family size, tax liabilities, noncash income from assets (e.g., imputed rent on owner-occupied homes), and Medicare benefits and concluded that the real income of the elderly was 101 percent of the median for nonelderly.

c. Radner, *An Assessment of the Economic Status of the Aged*, p. 43.

d. U.S. Department of Health and Human Services, Social Security Administration, Office of Research and Statistics, *Income of the Aged Chartbook, 1990,* Supplement 1992 (Washington, D.C.: U.S. Government Printing Office, 1992), p . 10.

tions), sufficient to finance the bulge in retirement benefits caused by the baby-boom generation. However, actuarial projections of the solvency of the Social Security trust funds have continued to deteriorate since 1983 and were revised down sharply again in 1994. Benefit outflows are now projected to exceed tax income beginning in 2013; and the OASDI balance is expected to be exhausted in 2029, thirty-four years earlier than envisioned in 1983.[26] Another way to look at the financial status of the Social Security program is to compare the present value of benefits expected to accrue to all past, present, and future workers over a specific time horizon with the present value of the assets (including future contributions) expected to accrue over the same time period. This provides a measure of the system's actuarial deficiency. The actuarial deficiency of the Social Security program by this measure is estimated by the Office of Management and Budget to be about $1.9 trillion.

The frequent revisions in the projections of Social Security funding highlight the great uncertainty about the future status of the Social Security trust funds. Nevertheless, if Social Security benefits and taxes are not changed, the most likely outcome is that the annual positive cash flow will end early in the next century and the trust funds will be quickly exhausted. If action is taken promptly, the measures necessary to fix Social Security will be less severe. Congress has already enacted a gradual increase in the normal retirement age, and there are several proposals to reduce Social Security benefits and raise tax rates. Senator Robert Kerrey and former Senator John Danforth, cochairmen of the Bipartisan Commission on Entitlement and Tax Reform, proposed fundamental changes in the Social Security retirement system that would bring future outlays and revenues to near balance. However, there is substantial political resistance to change in Social Security at the present time, and it now appears that no change will be implemented for some years.[27]

It should also be noted that a controversy has arisen concerning Social Security funding because the temporary positive cash flow that is now being realized (about $69 billion for OASDI in fiscal 1995) is used to purchase debt issues of the U.S. Treasury, which appear to merely finance government consumption. Of course, the *total* government deficit measures the impact of the government budget balance on national saving; thus, the impact of the positive cash flow in Social Security depends on how it affects decisions on non–Social Security spending and taxing. Social Security adds to national saving only if the annual excess of revenues over expenditures reduces the overall budget deficit. Many argue that the Social Security surpluses finance spending and therefore are merely an accounting device with little significance because they do not add to saving or encourage growth in the nation's capital stock.[28] In any case, the Treasury will have to increase taxes, borrow further, or cut spending in order to redeem these funds when expenditures begin to exceed revenues.

Funding for Government Employee Pensions. Nearly 10 percent of U.S. workers are public employees covered by federal, state, or local pension programs, mostly of the defined benefit variety. Unlike private employers, the public employer has no tax incentive to make pension contributions, and public pensions are not subject to the funding requirements of ERISA or backed by the PBGC. Years ago, many public employee retirement benefits, like other current expenditures, were paid from general funds. But such pay-as-you-go funding raised serious questions about intergenerational equity and the true cost to taxpayers of growing employment in the public sector. Today, prefinancing of public employee retirement benefits is generally a requirement, though regulatory details regarding public pensions differ substantially from state to state.

Government expenditures for pension funding compete with other public-sector needs and are therefore subject to budgetary

politics. There are many recent examples in state and local governments of politicians attempting to address a budget problem by skipping the annual pension contribution or by altering the actuarial assumptions underlying the funding. State and local pension funding has also been adversely affected by pressures to use pension funds for some special interest, such as the financing of public infrastructure or environmental programs. Often, it seems that concern about the credit rating of the government's debt is the only real constraint on abuses of public pensions.

Although there seems to be great variability, a substantial number of state and local pensions are reported to be underfunded. A recent General Accounting Office (GAO) report found that 75 of 184 pension plans studied contributed less than the actuarially required amount in 1988. Others have estimated an average funding ratio of 80 percent across all state and local pension plans. Unfortunately, data problems make it difficult to be more precise about this issue. Nevertheless, it is clear that underfunding is a serious problem for many government pensions and that future tax burdens will rise sharply to overcome this situation if funding is not increased (or benefits cut). **CED recommends that defined benefit plans sponsored by state and local governments be subject to minimum disclosure and funding standards. Plans should be fully funded, and promises that cannot be funded should be avoided.**

Table 3

Comparison of Initial Retirement Benefits and Contributions Made by Public- and Private-Sector Employees for Defined Benefit Plans and Social Security

		Public Sector	
Item	Private Sector	Without Social Security	With Social Security
Combined Social Security and pension benefits as a percent of final earnings			
Final earnings, $35,000	66.4%	65.4%	87.0%
Final earnings, $65,000	57.6	65.4	73.3
Total contributions to Social Security and pensions as percent of final earnings			
Final earnings, $35,000	6.2	7.6	11.3
Final earnings, $65,000	5.5	7.6	10.6
Ratio of initial benefit to contribution in final year			
Final earnings, $35,000	11 to 1	9 to 1	8 to 1
Final earnings, $65,000	10 to 1	9 to 1	7 to 1

SOURCE: William J. Wiatrowski, "On the Disparity Between Private and Public Pensions," *Monthly Labor Review* (April 1994): 3–9.

Federal employee pension programs underwent substantial reform in the 1980s, providing less generous defined benefit packages that are expected to limit the growth of future liabilities. Moreover, stability in federal civilian employment and downsizing by the military should reduce the growth in pension benefits. New federal employees and previously hired workers who joined the new Federal Employee Retirement System are now covered by Social Security, a reduced defined benefit plan, and a defined contribution plan. Given present levels of employee and employer contributions as well as statutory funding by agencies, these civilian and military retirement programs are expected to maintain solvency. But a substantial unfunded liability exists for earlier service under the older Civil Service Retirement System. Indeed, the actuarial deficiency for civilian and military pensions *combined* is estimated to be $1.5 trillion. (The actuarial deficiency at the end of 1992 was $881 billion for the civilian and $619 billion for the military retirement systems.) Moreover, federal pension trust funds are invested in U.S. Treasury debt. Therefore, as with Social Security, at some future point the Treasury will be required to tax or borrow to redeem these pension funds.[29]

It is often pointed out that where there is a "problem" public employee pension program, it may be the case not only that there is underfunding but also that too much has been promised. When strapped for cash, some governments have substituted pension increases for pay raises in order to satisfy the demands of workers, thereby magnifying funding problems and passing on the burden to future taxpayers.[30] But as a general rule, public sector pensions do not appear to be more generous in the *initial years* than private sector pensions when individual contributions are taken into account (see Table 3).[31] However, the fact that public sector pensions are more likely to be fully indexed for inflation makes such pensions more attractive over a longer period.[32] Of course, indexing for inflation also raises the cost of such plans substantially compared with the cost of plans that are not indexed.[33]

EXPECTATIONS OF THE BABY BOOMERS FOR RETIREMENT INCOME

Past experience has encouraged each generation of Americans to anticipate an improvement in its living standards. The experience of the elderly population in the United States is no different. In fact, their economic status has improved both in absolute terms and relative to that of younger workers (see Table 4). The median real income of the nonelderly is estimated to have risen 31.8 percent between 1967 and 1990, whereas the income of the elderly (adjusted for family size) is estimated to have risen 82.8 percent. The rapid rise in the income of the elderly relative to that of the nonelderly was largely due to increases in Social Security benefits, increased coverage by private pensions, and growing income from assets.[34] The question remains: How have the gains of current retirees affected the expectations of workers? Polls seem to present contradictory answers. Many younger workers report that they do not expect to benefit from Social Security, but they generally strongly oppose its elimination.

The recent experience with declining saving rates and rising female participation in the

Table 4

Annual Percent Change in Real Median Family Unit Income Adjusted for Size

Years	Under Age 65	65 or Over
1967–1972	3.1%	4.9%
1972–1979	1.1	1.9
1979–1984	-0.3	3.4
1984–1990	1.0	0.9
Average change, 1967–1990	1.2	2.6
Total change, 1967–1990	**31.8**	**82.8**

SOURCE: Daniel B. Radner, *An Assessment of the Economic Status of the Aged*, p. 38.

labor force suggests that families will go to great lengths to maintain and improve living standards. In the past, retirees have used political power to enhance their living standards, and there is no reason to assume that this will not happen in the future. Because of the intergenerational compact involved in Social Security, many workers view their entitlement to future Social Security benefits as inviolable, like a property right.

If future retirees expect their living standards to improve as much as those of earlier generations of elderly, they may be in for a rude awakening unless pension saving is sharply increased. However, as we indicated in Chapter 2, there is evidence that many workers do not have adequate information about pension saving and that, consequently, their expectations about their economic circumstances in retirement may be unrealistic.

HOW MUCH SHOULD WORKERS SAVE FOR RETIREMENT?

Information on the savings needed to purchase a specific retirement annuity is available. Given assumptions about investment income, wage growth, age at retirement, and other factors, one can also estimate the required share of income that must be saved to achieve a specific retirement annuity. For example, the data in Table 5 indicate that an individual's annual private pension saving would have to be 13 percent of wages over a thirty-five–year period in order to receive at age 65 a fully indexed private pension that paid 50 percent of final pay. As Table 5 demonstrates, early retirement and a reduction in the number of contributory years have a large impact on the required saving percentage. Another crucial factor affecting required saving is the assumed rate of return on the invested funds. The example in Table 5 is based on a real return of 4 percent. By employing a more aggressive investment strategy (e.g., a portfolio allocation that places a higher percentage of savings in equities and a lower percentage in money market funds), it may be possible to exceed this rate of return and achieve the same replacement ratio with lower contributions (see "Retirement Benefits and Saving Requirements").[35] Thus, it is important that participants understand the relation between risk and return.[36]

Available data on pension saving suggest that very few workers have an annual private pension saving rate anywhere near that required to generate a pension of 50 percent of final pay. In 1991, the combined total contribution to private pensions by employers and employees appeared to be about 2.9 percent of disposable personal income, down significantly from about 3.9 percent in 1980. Part of the decline after the mid-1980s was due to newly enacted full-funding limits. The average business contribution to pension and saving plans is about 3.6 percent of payroll for all

Table 5

Percent of Earnings that Must Be Saved to Finance a Fully Indexed Pension of 50 Percent of Final Pay

Number of Contributory Years	Retirement Age			
	55	60	65	70
20	34%	31%	28%	25%
25	25	23	21	18
30	19	18	16	14
35	15	14	13	11
40	—	11	10	9

SOURCE: These estimates were provided by Don Ezra, managing director of Frank Russell Company. The underlying assumptions are as follows: (1) The investment return is 4 percent greater than the rate of inflation. (2) Salary escalation throughout the working career is 1 percent higher than the rate of inflation. (3) Pensions are paid monthly so long as either the retiree or the spouse of identical age is alive. (4) Mortality after retirement is expected to follow the 1983 Group Annuity Mortality Table.

industries and probably about 5.5 percent for all industries that have pensions.[37] Of course, these figures do not include contributions to Social Security, which are quite large; but for most retirees, Social Security will not provide adequate income in retirement.

Unfortunately, the need for additional private saving does not appear to be well understood, though some pension plans (especially defined contribution plans) provide workers with adequate information. Many workers are unaware of the size of their employer-provided pensions and the additional retirement saving required to achieve their objectives for retirement income.

UNDERSAVING BY BABY BOOMERS

How much are the baby boomers undersaving on average? The answer depends in part on how much income they expect in retirement. Perhaps some baby boomers are willing to accept a very modest standard of retirement income. A recent study by the Congressional Budget Office (CBO) used the following standard to judge the adequacy of ongoing preparation for retirement: Will the baby boomers' real income and wealth in retirement exceed that of their parents? The study answered this question in the affirmative for several reasons: (1) The preretirement real income of the baby boomers is expected to exceed that of their parents, thereby automatically triggering higher Social Security or pension benefits. (2) Higher workforce participation rates by women of the baby-boom generation will increase their eligibility for pensions. (3) Changes in pension regulations pertaining to vesting and participation make it more likely that the baby boomers will receive a pension. (4) The baby boomers are likely to inherit more wealth.[38]

RETIREMENT BENEFITS AND SAVING REQUIREMENTS

Most retirees will require more income than provided by Social Security. Individuals frequently ask: How much retirement saving is necessary? Fortunately, a reasonably accurate answer can be provided, given a number of assumptions. Once an individual has decided on a desirable level of retirement saving, the share of earnings that should be set aside for retirement by the individual and/or an employer depends on such factors as whether the retirement benefits are adjusted for inflation, the number of years that pension contributions are made, the return on investments in the retirement fund, and the expected age of retirement. In the example shown here, the required saving rate is lower than in the example presented in Table 5 even when the retirement income target (50 percent of final pay, indexed for inflation) is identical. The principal reason is that a higher investment return (6 percent after inflation until retirement and 5 percent after inflation thereafter) is assumed in this example, reflecting a portfolio allocation that takes on a higher degree of risk.

Required Saving as a Percent of Income

Desired Retiree Income as a Percent of Annual Salary	Years to Retirement					
	10	15	20	25	30	35
30%	36%	21%	13%	9%	6%	4%
40	48	27	18	12	8	6
50	60	34	22	15	10	7
60	72	41	26	18	12	9
70	84	48	31	21	14	10

SOURCE: T. Rowe Price Associates. The underlying assumptions are as follows: (1) A 9 percent annual investment return prior to retirement and 8 percent after retirement, (2) an inflation rate of 3 percent, (3) retirement income lasts thirty years.

However, in keeping with the CBO's practice of not forecasting Congressional actions, the evaluation of the future well-being of baby boomers employed current-policy fiscal assumptions. The study assumed no change in promised Social Security benefits, even though current Social Security benefits cannot be maintained without a very sharp rise in Social Security taxes, given demographic trends. A realistic projection needs to address the tax burden on workers and the political and economic pressures to reduce benefits. In this respect, the CBO policy assumption begs the question of whether the retirement income of baby boomers will be satisfactory.

A recent study based on generational accounts, which takes into consideration the financing of government-projected liabilities for retirement and other programs, concludes that the majority of baby boomers will actually have a lower standard of living in retirement, in absolute terms, than their parents now enjoy. This is because currently legislated government policies (e.g., for retirement and health care) have passed forward a massive burden to future generations. Consequently, a sustainable fiscal policy will require substantial spending cuts and tax increases.[39]

It has also been pointed out that current retirees have enjoyed fortunate circumstances that are not expected to benefit baby boomers. For example, many current retirees had large windfalls from the rise in housing prices and the decline in the real value of liabilities (mortgages) resulting from inflation. In contrast, recent economic research suggests that the baby boomers will experience a decline in the real value of their investment in housing, which represents a very large portion of their wealth.[40] The widespread use of adjustable-rate mortgages also makes it less likely that they will benefit as their parents did from increased inflation.[41]

Recognizing the great uncertainty about long-term economic trends, it seems that the most likely outcome is that the baby boomers will experience a very large decline in economic well-being as they enter retirement. Given the rise in expectations brought about by the prosperity of current retirees, this decline in living standards may be widely viewed as unacceptable.

How much saving would be necessary for the baby boomers to maintain their preretirement living standard in retirement? An analysis that addresses this question was prepared by Professor B. Douglas Bernheim; it indicates that the baby boomers are very poorly prepared for their future retirement.[42] Employing a model of life-cycle behavior with currently prescribed Social Security benefits, and using survey data on household assets and consumption, Bernheim estimated that households with a head age 35 to 44 were accumulating assets at only 34 percent of the required rate. *Thus, the baby-boom generation needs to triple rates of asset accumulation.* He also found that saving adequacy is lower for single individuals and tends to decline as income rises, reflecting the progressivity of Social Security benefits and inadequate private pension saving. Moreover, if future Social Security benefits are cut even moderately, the required increase in saving will rise substantially.

The Bernheim study did not take into account the fact that many retirees have substantial equity in their homes. The increase in saving needed to maintain preretirement living standards could be less if the baby boomers were willing to cash in on their equity in housing when they retire. Home equity is estimated to account for about 70 percent of the total wealth of the elderly; therefore, home equity conversion, by sale or reverse mortgage, is a possible means of significantly increasing consumption by retirees. But as we noted earlier, recent projections indicate that the baby-boom generation is not likely to benefit from a rise in the real value of housing. Moreover, studies show that the housing turnover rate among the elderly is very low, even though many retirees are fully aware of the potential for equity conversion.[43] Some eld-

erly become emotionally attached to their homes and familiar surroundings. Others wish to retain home equity as a reserve for meeting catastrophic medical expenses. Therefore, although housing equity should be taken into consideration when measuring the well-being of retirees, the existence of home equity may not greatly affect retirees' perceptions about the adequacy of their income.

These facts on demographic trends, private retirement saving, the funding of private and public pensions, and projected retirement income strongly support the conclusions that retirement saving is inadequate and that increased emphasis on private saving is necessary both to ensure the economic security of future retirees and to avoid unreasonable burdens on future workers. Although precise estimates of individual saving needs are inherently controversial, in part because of the difficulty of identifying reasonable retirement needs, CED believes that a massive increase in private retirement saving over the next decade is necessary if we are to avoid a crisis in retirement finance in the future. Clearly, Congress needs to take steps to remove current disincentives for retirement saving (see Chapter 5).

Chapter 4

Designing Tax Incentives to Raise Saving

Government tax policy is the major tool for encouraging retirement saving. For many years, federal income tax laws have included provisions to encourage business and individuals to make contributions to retirement funds. However, the deferral of taxes on pension saving is very controversial and has changed radically over time. Recent changes that have sharply limited tax benefits for pensions were motivated by rising political pressures to reduce the huge federal budget deficits and by the belief that tax incentives are a windfall because they have little effect on saving.

THE TAX BASE CONTROVERSY

The treatment of pensions in the federal income tax system is central to the longstanding debate about the economic impact and equity of a system that includes saving in the tax base. Some favor a consumption-based system that exempts saving from taxation either because of its desirable economic effects (i.e., because it encourages saving and long-term economic growth) or because they believe that the exemption will improve tax equity. Proponents of the basic philosophy underlying an income tax system generally espouse the traditional view that all increments to available resources should be taxed (i.e., that taxable income is the sum of consumption plus the change in net worth). Although this approach holds that all income, including saving, should be taxable, in practice, capital gains are generally not taxed until realized; and numerous tax deductions, exemptions, and credits have been added to the present income tax system in order to achieve particular objectives. Thus, for example, interest payments on mortgages are deductible in order to encourage home ownership, and pension contributions are deductible in order to encourage saving. Some of these practices have changed the character of the income tax, moving it in the direction of a consumption tax. Of course, if the income tax were replaced by a consumption tax, special tax provisions for pension saving would not be needed because the exclusion of saving would be the normal tax treatment.

The debate concerning the appropriate tax base has again entered the political arena because of growing support for the consumed-income tax, which would exempt saving from taxation. The issue is whether the United States should place greater reliance on taxing consumed income, rather than comprehensive accrual income that includes all consumption and increases in net worth. There is no consensus among scholars or in the business community on this issue.

We do not propose to address the debate about the tax base in this policy statement.[1] **This statement is deliberately focused on retirement saving.** Of course, we recognize that the general debate is relevant to the discussion of retirement saving and fiscal policy more generally. With respect to retirement saving, tax preferences are seen as a subsidy or incentive by those who view income as the appropriate tax base, whereas the absence of tax-qualified retirement savings is seen as a penalty or disincentive by those who view consumed income as the proper tax base.[2] The

policy position that we take on retirement tax preferences in this statement is that with the existing income tax, the case is compelling for broadening and simplifying the rules relating to tax-qualified retirement savings. Even if this constitutes a subsidy or incentive, we nevertheless endorse it as being in the public interest.

Without taking a position on the tax base controversy, we assume in this report that the federal government will continue to rely on the present income tax system.

TAX INCENTIVES AND SAVING

A critical question about the current practice of employing income tax preferences to encourage pension saving is: How effective are these incentives? The impact of tax incentives on pension saving is part of the broader issue of the determinants of saving, which has confounded scholars for generations. Economists have approached the issue by asking: What is the effect of changes in the after-tax rate of return on private saving? Theory alone does not provide the answer. An increase in the rate of after-tax return lowers the price of future consumption, thereby increasing the incentive to save. But an increase in the return on saving also reduces the amount of saving necessary to achieve a given level of future consumption, thereby reducing the saving incentive for *target* savers.[3] Empirical studies intended to determine which effect predominates tend to support the view that net saving does increase when the after-tax return rises; however, this finding is not unanimous and nearly all studies find that the effect is quite modest.

The recent experience with IRAs, which grew rapidly when introduced but much less so after eligibility for a tax deduction was restricted to lower-income households, has presented researchers with an opportunity to study the effect of targeted tax incentives on saving. Before its implementation, most economists expected that the tax advantages would generate a sharp rise in IRA balances (as happened), but many feared that IRAs would not produce a significant increase in total personal saving. This is because the tax benefit could be received by households that merely shift existing savings into IRAs and by households that borrowed to finance IRA contributions. In either case, taxpayers would receive a windfall in the form of lower taxes with no net increase in aggregate household saving. Many empirical studies have been undertaken in an attempt to determine how much of IRA saving was new saving. Several, though not all, of these studies have concluded that IRAs and other tax incentives were powerful incentives for the creation of *personal saving*.[4]

A far more demanding and relevant test of the success of tax-preferred saving incentives such as IRAs is their effect on *national saving*. National saving is the sum of private saving (by individuals and business) and government saving (or dissaving). The impact on national saving is important because, together with inflows of foreign capital, national saving provides the funds for investment. Whether a tax incentive generates an increase in national saving depends on the amount of additional private saving, the amount of revenue lost by the government, and whether government spending is affected by the loss in revenues. If the new private saving does not exceed the government's revenue loss, national saving will not increase and might actually fall, providing that the deficit rises by the amount of the revenue loss. Of course, unlike the response of private saving to tax incentives, the use of federal revenues (for spending or for deficit reduction) is a politically determined issue that depends on the current priorities.

Putting aside the political issue concerning the government's use of revenues, the impact of tax preferences on national saving depends on the taxpayers' marginal tax rate and on the fraction of contributions to IRAs and other incentives that is *new* saving (i.e., that does not represent a shift into IRAs of other non-tax-deferred saving). If, for example, 50 percent of the contribution to pension funds is

new saving generated by the tax incentive and the relevant effective marginal tax rate is 30 percent of income, a $100 contribution to the pension fund could cause *national saving* to rise by $20 because the tax incentive would generate more dollars of new private saving than the government's revenue loss.

Because it is difficult to determine what proportion of contributions is new saving, it is not surprising that the results of empirical studies on the net impact of IRAs and other saving incentives on national saving are not unanimous. However, it is significant that a recent study by Poterba, Venti, and Wise, based on the U.S. experience with 401(k) plans, concluded that these tax-deferred saving incentives succeeded in generating substantial new saving sufficient to significantly increase not only personal saving but also national saving.[5] Moreover, researchers who have found that tax incentives created little or no new saving, because of the induced shift from existing assets, generally agree that national saving should rise in the long run. For example, recent model simulations of long-term outcomes by Engen, Gale, and Scholz strongly support the finding that over time, the impact on national saving will be positive.[6]

Thus far, we have discussed the effects of tax incentives, such as IRAs, that are designed to encourage retirement saving by individuals. However, tax deductions for employer contributions made from current-year earnings may have a larger positive impact on national saving. A high proportion of employer contributions to retirement plans are likely to be *new* savings, that exceed the government's revenue loss, given the usual assumption that wages would be higher in the absence of retirement benefits. Employees are not likely to change their saving behavior in response to a change in employer contributions because they frequently have very little information about those contributions; employees are more concerned about the size of the benefit than about how it is financed.

Therefore, it is reasonable to conclude that certain existing tax incentives for retirement saving, as well as employer contributions to pension plans, are likely to increase national saving.

DESIGN OF TAX-PREFERRED SAVING INCENTIVES

It is important that future saving incentives be carefully designed to maximize their net benefit. The shifting of funds from existing saving to qualified saving and borrowing to finance contributions should be discouraged as much as possible. Some have suggested, for example, that tax-preferred saving incentives could be made more effective by making deductions available only for increases in saving or only for saving above a threshold that rises with income.[7] The idea is that a tax incentive should reward greater efforts to save.

It is also important that the tax incentive be designed so that those who have discretion to increase saving qualify for the incentive. Using data on educational attainment (which is correlated with income), one study found that college graduates and those who already have pensions respond positively to saving incentives, whereas those without college degrees may reduce saving in response to tax incentives. Apparently, lower-income individuals are much more likely to behave as target savers. The study concluded that "a policy that provides tax incentives for saving exclusively for lower-income households excludes those households that are most likely to increase saving in response to this policy; indeed, it is conceivable that such policies could actually reduce aggregate personal saving."[8] Of course, if an incentive does not generate a significant increase in personal saving, there is little hope that national saving will rise. **Thus, pension-related tax incentives that decline as income levels rise may be self-defeating if the goal is to encourage aggregate pension saving.**

In some instances, the motive for tax changes that have reduced the tax benefits

available for high-wage individuals is to compensate for the fact that in any given year, pension tax policies provide considerably fewer benefits for low-wage workers. Indeed, some have cited the distribution of pension tax benefits as reason to increase taxes on pension saving.[9] However, in a given year, many of those who do not benefit are younger workers who are not yet covered by a pension but who will ultimately be covered and benefit from the tax treatment of pensions. Measured in terms of lifetime earnings, rather than earnings at a specific time, pension tax benefits appear to be more evenly distributed.[10]

We conclude that pension tax policy is not a good instrument for redistributing income. Proposals for reducing pension tax benefits for high-wage workers are clearly not desirable from the viewpoint of increasing national saving and may not be effective even from the viewpoint of distributional policy. Moreover, if society finds the distributional implication of pension policies worrisome, this can be fixed by other changes in taxes (e.g., rates or exemptions).

On the issue of the design of tax-deferred incentives, **CED concludes that private pension participation and saving should be encouraged, but in a manner that is most likely to raise national saving as well. Other legitimate concerns, such as income distribution, cannot easily be addressed with private pension policies without defeating a basic objective of retirement policies: to increase saving.**

PROPOSALS FOR COMPULSORY SAVING PROGRAMS

It has frequently been observed that some households are savers and others, including some middle-income households, do little or no saving. Moreover, it appears that the behavior of these nonsaving households changes little, if at all, in response to incentives to save. Consequently, some scholars have proposed a mandatory qualified saving program — a requirement for a minimum rate of saving, such as 2 percent of disposable income, for all workers — in order to make sure that most households contribute to national saving and make preparations for the future. It is argued that this approach would be very effective in raising national saving because those who do not save would be forced to save and would have little opportunity to shift funds from existing accounts to qualified accounts. Those who already save the required minimum would not be affected by the proposal.[11]

A mandatory saving program probably would be integrated with Social Security, either as a private supplement to Social Security or as a substitute for the part of Social Security that provides benefits above basic needs. Either approach would increase *funding* for retirement, though the former is likely to make a greater contribution to saving. Proponents of mandatory saving plans also argue that the fact that individuals would own and control the funds would make mandatory contributions more attractive than mandatory taxes paid to Social Security.

We do not dispute the idea that mandatory saving programs could be more effective in increasing private saving than other currently available options. But policies that *force* individuals to take certain actions often have great costs to society relative to policies that merely encourage certain behavior. For example, a requirement for annual contributions could cause considerable inconvenience for families experiencing temporary economic hardships. Moreover, the American public instinctively resists any compulsion; therefore, it is doubtful that proponents of compulsory saving programs could garner widespread political support unless large net social benefits are clearly demonstrable. Thus, **although CED believes that proposals for mandatory saving programs merit further study, we do not endorse the idea at the present time.** The nation should consider a mandatory program only if other options for increasing saving, such as improved availability of pension information and tax incentives, prove to be ineffective.

THE BUDGET DEFICIT

As we mentioned earlier in this chapter, a number of tax changes were enacted during the last decade that have discouraged pension saving. The primary purpose of these tax changes has been to increase government revenues in order to reduce the federal budget deficit.[12] In seeking additional revenues, policy makers have often turned to the federal government's list of tax expenditures, which includes tax preferences for pension saving. **However, in our view, pension tax expenditures are not an appropriate target for deficit-reducing tax increases.** (See "Tax Expenditures and Pension Tax Preferences," below.) We also believe that the government's measure of the subsidy is exaggerated because the present value of future revenue gains is not taken into account.

CED has long advocated a change in spending and tax priorities in order to eliminate the federal budget deficit.[13] We have said that among major policy alternatives, a reduction in the budget deficit is the most certain and effective means of increasing national saving. In taking this position, however, **CED has argued that the purpose of reducing budget**

TAX EXPENDITURES AND PENSION TAX PREFERENCES

In its efforts to reduce the budget deficit during the last decade, Congress often sought to raise revenues by reducing *tax expenditures* in the budget. Tax expenditures were defined by the Congressional Budget and Impoundment Control Act of 1974 as "those revenue losses attributable to provisions of the federal tax laws which allow special exclusions, exemptions or deductions from gross income, or which provide a special credit, a preferential rate of tax or a deferral of tax liability." The Joint Tax Committee, which has responsibility for estimating the magnitude of tax expenditures, reports that the annual revenue loss as the result of the preferred tax treatment of pensions amounted to $56 billion in fiscal 1993, making pension contributions the largest tax expenditure in the budget. The Joint Tax Committee's estimate of tax expenditures for retirement plans is the annual aggregate of revenue losses measured on a cash-flow basis.

In principle, legislation designed to reduce tax loopholes may improve economic efficiency if the added revenues are used to lower statutory tax rates. However, it is clear that the method of measuring tax expenditures is misleading when applied to pension saving. A proper measure would balance taxes paid on future benefits against the immediate revenue loss; that is, it would use a life-cycle approach rather than the annual cash flow. This is because the calculation of annual cash flow is affected by changes in pension funding levels, trends in coverage and benefits, and the aging of the population, factors that have recently biased estimates upward. It is also important to realize that currently reported tax expenditures are not a true measure of forgone revenue (the amount of revenue that would be realized if the tax preference were ended) because the tax expenditure calculation does not take into account any taxpayer response to the increases in effective tax rates. If the preferential tax treatment of pensions were eliminated, such responses would surely lower the revenue gain implied by the tax expenditure estimate.

More important than these measurement issues, however, is the fact that the economic consequences of pension tax expenditures are different from those of other tax expenditures. Retirement saving has very positive social effects as well as important benefits for future retirees. Moreover, as explained earlier in this chapter, the preferential tax treatment of pension savings also makes an important contribution to national saving, which in turn improves the growth and competitiveness of the U.S. economy. This cannot be said about many other tax expenditures that encourage consumption rather than growth.

deficits is to increase national saving, which is needed to boost investment spending and to stimulate more rapid growth in productivity. Therefore, how the deficit is reduced is important. Deficit-reduction policies should give first priority to cuts in real spending. Although taxing private pension saving would reduce the budget deficit, such taxes are not an effective method of raising national saving because they reduce private saving. In contrast, taxes on consumption reduce the deficit without discouraging private saving and are therefore a more effective tax tool for increasing *national* saving.

CED agrees that further reductions in the budget deficit should be a high national priority. We believe that there is room for more spending cuts in the budget, certainly sufficient to offset any net increase in the budget deficit resulting from reforms of retirement law recommended here. This statement proposes legislative changes that both reduce current budget deficits (e.g., in Social Security) and increase current budget deficits (e.g., full funding of pensions). The short-term net deficit effect of these changes is unknown, but it is probably quite small. More important, the reforms recommended here will increase national saving and investment and thereby achieve the objectives sought by a reduction in the budget deficit.

CED has noted elsewhere that any serious program of long-term spending restraint must substantially reduce the growth of entitlement and transfer programs, which have been the major source of budget growth.[14] As a practical political matter, it may also be necessary to raise taxes in order to enact further deficit-reducing measures. However, we believe that the desire to reduce current-year deficits should not lead to a political decision to increase taxes on retirement saving. Such a policy would lose sight of the economic rationale for reducing the deficit: to increase national saving in order to improve the growth and competitiveness of the economy.

Chapter 5

The Regulatory Tangle: Proposals for Simplification

Government policy toward private retirement saving has traditionally consisted of two broad features: First, under the Internal Revenue Code, savings for retirement have been accorded favorable tax treatment: deferral of income taxes on contributions and on the investment earnings derived from them. The second general feature has been regulation of plan design and conduct under the Internal Revenue Code and federal labor law.[1]

FAVORABLE TAX TREATMENT

Since the 1920s, employer and (under various arrangements) employee contributions to pensions have been deductible from current-year income up to certain limits. However, taxes are merely deferred; taxes on contributions and invested earnings become payable upon distribution of retirement benefits to the employee. The Internal Revenue Code requires compliance with participation, vesting, and funding rules in order to qualify a plan for tax benefits. This favorable tax treatment of income set aside for pensions is a recognition of the importance of retirement income to the economic security of retirees and the contribution of retirement saving to the national economy as a source of investment funds.

FEDERAL REGULATION

Labor law sets out mandatory requirements for all private pension plans, whether qualified or not. These requirements, which cover participation, vesting, funding, reporting, and fiduciary responsibility, came about largely in response to rapid growth in the number of pension plans, from 400 in 1925 to more than 370,000 by 1974[2] (when there was a major overhaul of regulation), and the heightened concern about potential abuses of pension tax preferences. The principal factors that motivated federal involvement were:

- Pension promises made by firms to employees could be (and occasionally were) revoked.
- Plans eligible for preferential tax treatment could be established solely for the benefit of certain key company employees, thereby raising issues of tax equity.
- Employees could be excluded from participation through restrictions on age and length of service combined with timely terminations.
- Pension benefits distributed to key employees were sometimes viewed as excessive in relation to perceived retirement needs.
- Plans were often underfunded relative to their future liabilities.
- Plans were overfunded in some cases for the purpose of tax avoidance.

CED agrees that some government intervention in the private pension system is called for. However, the pension regulations that have been enacted place excessive limits on the ability of individual plans to be tailored to individual needs, are much too complex, have been far too unstable, and seek to achieve too many goals, some of which are of little or no benefit to society. Indeed, many regulations currently on the books conflict with the goals of pension policy as CED sees them.

We believe that the *basic* goal of pension policy is to ensure the economic security of the elderly by encouraging saving. In our evaluation of present pension regulations and in our recommendations for reform, **CED takes the view that pension regulation must be streamlined, simplified, and designed to achieve six basic objectives:**

1. **Provide retirement plans for the largest-possible number of workers.**
2. **Ensure that pension plans meet appropriate fiduciary standards and are funded to fulfill pension promises.**
3. **Encourage individual saving by making retirement saving opportunities available to all workers through deferred taxes on contributions and earnings and by providing all workers with realistic information on their retirement saving needs, resources, and options.**
4. **Place simple and reasonable limits on tax preferences received by any individual (i.e., a single overall limit on eligible contributions indexed to inflation) and a limit on benefits received from a qualified defined benefit plan.**[3]
5. **Preserve retirement saving and pension rights by discouraging preretirement withdrawals and by improving the portability of pension assets.**
6. **Compensate for the rise in life expectancy by encouraging retirement at a later age and by reducing work disincentives for the elderly who receive retirement benefits.**

Simplifying pension regulation to achieve these objectives will also result in much lower administrative costs than under the current regulations.

ERISA AND SUBSEQUENT LEGISLATION

Beginning in the 1930s, Congress moved gradually to regulate pensions. Nondiscrimination rules and limits on funding of defined benefit plans were already in place by the time the Employee Retirement Income Security Act of 1974 (ERISA) was passed. This extremely complicated legislation was a major overhaul of pension law and, together with numerous amendments, remains the basic pension law today. (The Appendix presents the chronology of pension legislation in greater detail.) ERISA addressed all aspects of retirement plan design and funding; its primary goal was to broaden pension participation and ensure the deliverability of pension promises.

To achieve these goals, ERISA established age and service rules designed to make retirement plans available to a greater number of rank-and-file employees and vesting rules to increase the probability that benefits were actually received. It established fiduciary standards for all plans, minimum-funding rules for defined benefit plans, and insurance to protect participants against the loss of pensions. ERISA required that this insurance be funded by employer premiums and created a new government insurance agency, the Pension Benefit Guaranty Corporation (PBGC), to administer it. ERISA also gave workers whose employers did not offer a retirement plan a chance to enjoy tax-favored retirement saving by creating IRAs. ERISA was followed by legislation in 1978 and 1981 creating new retirement-saving vehicles, including 401(k) plans, and broadening access to others (permitting IRAs for all workers).

At the same time, other provisions of ERISA and subsequent legislation have discouraged the growth of retirement savings. ERISA placed limits on contributions to all pension plans and penalized excessive individual benefits from defined benefit plans. Nevertheless, until 1982, it could be argued that the inherent tension between limiting immediate federal revenue losses and encouraging retirement saving had resolved itself in favor of the latter. However, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) marked the beginning of a change in priority. TEFRA

and most subsequent important changes to pension regulations were legislated in an environment of large federal budget deficits and focused primarily on limiting immediate federal revenue losses. Consequently, TEFRA and successive laws passed almost annually during the last decade have concentrated on increasing the stringency of contribution and benefit limits and erecting ever more elaborate rules to safeguard against discrimination. These funding and benefit restrictions are backed by tax penalties for noncompliance: a 10 percent excise tax on excess contributions and a 15 percent tax on excess distributions (annual benefits in excess of $148,500 in 1994).

Some parts of ERISA and subsequent legislation have had beneficial effects. But pension regulation has also had detrimental consequences:

- It has sharply raised the cost of administering retirement plans, with a disproportionate impact on smaller defined benefit plans. This trend has coincided with a steep increase in the number of terminations of defined benefit plans.
- It has significantly limited pension contributions, undermining the ability of some plans, even those that are currently healthy, to make good on their pension promises in the future. This has contributed to the growing underfunding problem.

The complexity of private pension regulation in the United States cannot be exaggerated. For example, the nondiscrimination rules, which are over 600 pages long, require complex numerical calculations for every employee each year. To ensure compliance with these and other provisions of pension regulation, plan administrators must hire an army of lawyers, actuaries, and accountants, who often seem to be the major beneficiaries of the legislation. As an industry publication noted: "There are currently penalties for putting too much or too little into a plan, taking too much or too little out of a plan, and receiving benefits from a plan too early or too late."[4] Some legal experts have suggested that regulations are now so complex that it may be impossible for individual pension plans to be in compliance with all of ERISA's provisions.

REGULATIONS LIMITING PRIVATE PENSION CONTRIBUTIONS AND BENEFITS

Regulations enacted in the last decade or so reduced pension saving in several ways, including lowering the funding limits on defined benefit plans, limiting annual contributions and benefits for any individual, and introducing complicated new discrimination tests that sharply raised the administrative cost of delivering pensions, thereby discouraging their use. We deal here with only the most pernicious of these regulations. (Estimates of the cost of these regulations are included in the last section of this chapter, "Rising Regulatory Costs Discourage Pension Saving," beginning on page 64.)

There are two broad classes of pensions: *defined benefit* plans and *defined contribution* plans. The essential difference is that the obligation for a defined benefit plan is expressed in terms of a benefit (the contributions being variable), whereas the obligation for a defined contribution plan is expressed in terms of contributions to the pension fund (the benefit being indeterminate). Consequently, problems of underfunded pension promises (discussed in Chapter 3) arise only in the case of defined benefit plans.

The primary pension plan for larger and older firms is generally of the defined benefit variety. The design and funding of these plans (see "Estimating Liabilities and Funding for Defined Benefit Plans," pages 52-53) are quite complicated, in part because they are heavily regulated and their benefits are partially guaranteed by the PBGC. Many employees prefer this type of plan because the risk and responsibility for providing the benefits fall on the employer and because the amount of the pension, usually based on years of service multiplied by a percentage of compensation or a flat dollar amount, is known with greater cer-

tainty. Employers often prefer defined benefit plans because they allow greater discretion in the timing of contributions than many defined contribution plans and in the use of deferred contributions (in lieu of wages) to attract workers. Managers also hope to reduce the cost of pension benefits by pursuing more aggressive investments than may be included in the portfolio of defined contribution plans. However, the administrative costs of complying with regulations pertaining to defined benefit plans significantly exceed those for defined contribution plans of comparable size.

Contributions to a defined contribution plan are made to an individual account established for each employee. The final benefit paid is based on the sum of these contributions plus return on investment and sometimes forfeitures that have been allocated to that account.[5] Defined contribution plans are attractive to employers because they are less complicated to administer than defined benefit plans and because funding costs are predictable, since contributions are based on a predetermined formula. These plans are also attractive to some employees because they are generally portable (i.e., they can be carried from employer to employer) and because it is easy to keep track of the current value of their benefit. Moreover, it is usually possible for employees to receive their benefits in a lump sum upon terminating employment with the sponsoring employer. Because they are used by small firms and individuals, the number of defined contribution plans is rising rapidly. Successive legislation has generated a large number of types of qualified defined contribution plans, sometimes making the choice quite complex. (See "Defined Contribution Plans," pages 54-55 for a summary of plan types.) The most rapid growth has occurred in 401(k) plans, which are often supplements to primary defined benefit retirement plans.

FUNDING LIMIT FOR DEFINED BENEFIT PLANS

From a national saving perspective, the most serious attack on retirement saving was contained in the Omnibus Budget Reconciliation Act of 1987 (OBRA87). This law limited funding of defined benefit plans to 150 percent of plan termination liability (benefits accrued to date). Before OBRA87, firms could fund up to 100 percent of their *projected liability*, which is based on actuarial calculations of the benefits plan participants will accrue over their working lives. The new limit established by OBRA87 caused delay in funding of many plans until the later years of a worker's career. For many firms future pension costs will rise sharply because backloaded funding costs will rise just as the baby-boom generation approaches retirement.

Table 6 (see page 56) reproduces a numerical example of how the funding patterns for individuals of various ages were disrupted by the new rule. The plan in the example pays a benefit of 1 percent of final-average salary for each year of service; it assumes a 5.5 percent annual rate of salary increase and a return on assets of 8 percent. The third column shows how the plan would be funded prior to OBRA87 using the projected unit credit method. Contributions rise slowly as a percent of compensation throughout the worker's career. The present value of contributions during the first half of the worker's career is exactly equal to the present value of contributions during the second half. However, for the 25-year-old worker whose pension is funded exclusively under the OBRA87 rule, contributions as a proportion of salary begin at a much lower level and rise very steeply during the worker's forties and early fifties (see Figure 25, page 56). On a dollar-present-value basis, 75 percent of this employee's funding is pushed back to the second half of his or her working life. For the 35- and 45-year-old employees in this example who had already received benefit credits when OBRA87 took effect, *contributions had to be temporarily halted* (for nine and six years, respectively) while accrued benefits caught up with the amount that had already been funded under the pre-OBRA87 rules.

Recent empirical studies have concluded that the full-funding limitation introduced in OBRA87 substantially reduced pension contributions.[6] Data gleaned from surveys of businesses sponsoring pension plans support the conclusion that the effects of OBRA87 were significant. Prior to the enactment of OBRA87, the Wyatt Company concluded that 40 percent of 664 defined benefit plans it examined would have been affected by the new funding limit in 1987; that is, under pre-OBRA87 actuarial assumptions, these plans could have been expected to make contributions amounting to more than 150 percent of termination liability. A survey they conducted in 1987 revealed that 48 percent of the plans met or exceeded the 150 percent limit and were consequently overfunded according to the new rule; by 1992, that percentage had dwindled to 37 percent as firms cut back on their contributions to avoid being overfunded.[7]

Firms can only ensure the viability of their defined benefit plans if they are permitted flexibility to spread the costs of funding plans over time in a manner that realistically reflects both expected plan liabilities and the firms' ability to make contributions. The full-funding limit based on termination liability denies such flexibility and places a disproportionate burden on firms in the later

ESTIMATING LIABILITIES AND FUNDING FOR DEFINED BENEFIT PLANS

A typical defined benefit plan credits an employee with a unit of benefit for every year of participation in the plan, usually expressed as a percentage of compensation, though sometimes as a flat dollar amount. In the former case, compensation is usually based on career-average, or final-average, earnings for a specified number of years (often three to five) immediately prior to retirement. A simple example of the final-average case is an employee who works for thirty years until retirement at age 65, averages $50,000 in salary for his last five years of employment, and participates in a plan that credits him with 1.5 percent of final-average compensation for each year of service; he would be entitled to a pension of 45 percent of $50,000 ($22,500) for each year that he lives in retirement. In many cases, the pension benefit is in addition to Social Security benefits.[a]

Because accrual and payment of benefits occur over a period of many years, it is necessary for the plan sponsor, for purposes of funding, to first determine the present value of the pension. This involves several steps:

1. Estimating the final-average (or career-average) salary, which incorporates assumptions about rate of salary growth from commencement in the plan until retirement. This salary figure is then multiplied by the benefit percentage specified in the plan formula (1.5 percent in the example) and then by years of service to get the total annual retirement benefit. (The expected value of benefits for a group of participants in a plan would also be reduced by the probabilities of preretirement termination, disability, or mortality.)
2. Calculating the value at age 65 of all post-retirement benefit flows. This requires a mortality assumption to estimate life span and an interest rate assumption to discount the value of benefit payments made over successive years. The number thus derived represents the total pension benefit valued at age 65 (or whatever the retirement age).
3. Finding the present value of the number calculated in step 2. This calculation depends critically on the interest rate assumption. Because a long period of time elapses between benefit accrual and retirement, a small change in the interest rate causes an inordinately large movement in the valuation of plan costs and consequently in the funding status of the plan.[b]

The plan sponsor next has to determine how to assign the cost of funding this liability over time within the constraints of minimum and maximum annual funding requirements set out in the law.

years of workers' careers. CED therefore recommends that the funding limit be restored to its pre-1987 level of 100 percent of projected plan liability. Projected plan liability in the case of flat-benefit plans should be calculated to include anticipated increases in the dollar benefit level over time.

REDUCTIONS IN CONTRIBUTION AND BENEFIT LIMITS

Over the years, Congress has enacted a series of regulations intended to raise revenue by reducing retirement benefits for higher-income workers, business owners, and key employees. These changes are in conflict with the basic pension policy objective of encouraging retirement saving. Moreover, it turns out that these rules, in combination with discrimination rules, have a substantial adverse effect on retirement saving by middle- and lower- income workers.

Dollar Limits on Contributions and Benefits. Pension plan benefits and contributions are limited in a number of ways. There are limits on deductible contributions for both defined benefit and defined contribution plans, backed up by an excise tax penalty. There is a limit on the benefit that can be received from a defined benefit plan, and there is an excise tax on aggregate distributions of more than

Allocation of costs to each year is determined using one of six *actuarial cost methods* allowed by ERISA. The allocation for any given year is called the *normal cost* of the plan for that year. The minimum-funding requirement stipulates that the normal cost of the plan must be funded, in addition to amortization of unfunded liabilities, *experience* gains or losses (which occur when actuarial assumptions such as the interest rate differ from actual plan experience), and gains or losses arising from changes in the actuarial assumptions themselves.

Each of the actuarial cost methods is tailored for different preferences. Some are designed to fund benefits at a fairly stable percentage of payroll, some front load contributions into the earlier phases of a worker's tenure, and others do the reverse.

Because plans are usually designed so that benefits rise as a worker advances in age, it frequently makes sense (particularly for mature firms on a solid financial footing) to smooth out the cost of funding pensions over time. This can be achieved by using an actuarial cost method geared to making sufficiently high contributions in the earlier part of a worker's career so that contributions do not have to rise steeply in later years.

It should be noted that in 1987, the Financial Accounting Standards Board mandated that firms use the projected unit credit method for *reporting* pension liabilities in financial statements. This is one of the less conservative of the six allowable funding methods because it back-loads contributions (as a percent of compensation) into the later years of an employee's working life. Moreover, 1987 legislation that lowered the maximum funding limit to 150 percent of termination liability effectively delayed the funding of many workers' pensions. Since the work-force will age as the baby boomers move toward retirement, any laws that backload the funding of pensions will make it particularly burdensome for firms to finance these plans.[C]

a. Assuming that pension benefits are independent of Social Security benefits, the individual in the example would probably receive a total annual retirement benefit of about $33,000, or two-thirds of preretirement earnings.

b. A 1 percent change in the interest rate assumption can alter the long-run cost of benefits for a typical plan by about 25 percent. Dan M. McGill and Donald S. Grubbs, Jr., *Fundamentals of Private Pensions*, 6th ed. (Philadelphia: Pension Research Council, Wharton School, University of Pennsylvania, 1989), p. 259.

c. Many firms apparently also shifted to this method for *funding* their plans, away from more conservative methods, thus reducing contributions. William G. Gale, "Public Policies and Private Pension Contributions," *Journal of Money, Credit, and Banking*, forthcoming.

$148,500 to any individual from one or more plans. There is also a limit on *considered compensation* (the compensation that can be taken into account in a benefit or contribution formula).

In 1982, TEFRA reduced by one-third and then froze until 1986 both the maximum annual *contribution* to a defined contribution plan and the maximum annual *benefit* that could be paid out by a qualified defined benefit plan. The Deficit Reduction Act of 1984 (DEFRA) extended this freeze on contributions and benefits until 1988.[8] The Tax Reform Act of 1986 (TRA) effectively extended the freeze on contributions beyond 1988. It also reduced the contribution limit by individuals

DEFINED CONTRIBUTION PLANS

MONEY PURCHASE PENSION PLANS

The important distinguishing characteristic of a money purchase pension plan is that contributions must be *definitely determinable;* that is, they are made according to a predetermined formula that is independent of fluctuations in the profits of the sponsoring employer. The contribution limit on behalf of each employee is the lesser of $30,000 or 25 percent of employee compensation. There are several different types of money purchase plans:

1. **Traditional money purchase plans.** The plan sponsor undertakes to make periodic contributions to employee accounts according to a formula, usually a percentage of employee compensation. These plans are frequently "contributory," meaning that contributions are made by both employer and employee. Except for plans established before passage of ERISA, which were able to convert to 401(k) plans, employee contributions are made from after-tax dollars and are not tax deductible.
2. **Target benefit plans.** Contributions on behalf of each employee are based on an actuarial estimate of the contributions required to achieve a specific target benefit upon retirement.
3. **Negotiated contribution plans.** The formula for contributions usually arises from collective bargaining and covers the employees of more than one firm. Contributions accumulate in a single fund, rather than individual accounts.
4. **Savings, or thrift, pension plans.** These always involve employee contributions (from after-tax dollars), although most such plans also provide for full or partial employer matching. The employee is typically able to choose from a range of rates of contribution, and the employer match is normally a uniform percentage of each employee's contribution.

PROFIT-SHARING PLANS

Profit-sharing plans must meet many of the same regulatory requirements as money purchase pension plans. The principal difference is that contributions are not definitely determinable and in fact need not be tied to profits at all. IRS regulations require only that contributions be "recurring and substantial." The limit on tax-deductible contributions is 15 percent of aggregate employee compensation. There are three principal kinds of profit-sharing plans:

1. **Conventional profit-sharing plans.** All required contributions are made by the employer.
2. **Thrift profit-sharing plans.** Employees make contributions, and these are matched by the employer, often using a formula based on corporate profits.
3. **Cash or deferred arrangements [CODAs, or 401(k) plans].** Employees can choose to receive distributions in the form of cash, or as tax-deferred contributions by the employer to a trust. The earliest CODAs were established out of employer contributions that were in excess of regular compensation, but over time the concept came to be applied to regular compensation, whereby employees enter into salary-reduction agreements with employers,

for one important category of defined contribution plans, 401(k) plans, from $30,000 to $7,000 (before adjustment for inflation). Profit-sharing plans were prohibited from applying the unused portion of their prior-year contribution limit to exceed the contribution limit in another year. This reduced the degree to which they could make higher contributions in profitable years to offset lower contributions in unprofitable years. TRA also reduced early retirement benefits from defined benefit plans actuarially in line with the normal retirement-age benefit limit established under TEFRA.

As a result of the changes to qualified contribution and benefit limits, and after subse-

and the amount of the reduction is placed in a tax-deferred account by the employer on the employee's behalf. The limit on these contributions was $9,240 in 1994. About half of 401(k) plans provide for some amount of matching contribution by employers. The combined limit is the same as for a money purchase pension plan ($30,000).

STOCK BONUS PLANS

1. **Traditional plans.** These are similar to profit-sharing plans, except that the benefits can be made available in the form of stock in the employer's company.
2. **Employee stock ownership plans (ESOPs).** These are stock bonus plans that are at least 50 percent invested in the securities of the sponsoring employer. Most ESOPs are invested exclusively in employer securities. A *leveraged ESOP* is one in which money is borrowed in order to purchase the stock.

INDIVIDUAL RETIREMENT PLANS

The principal kinds of individual retirement plans are *individual retirement accounts, individual retirement annuities,* and *simplified employee pensions.* The first two are funded by the worker and are distinguishable primarily by the type of funding instrument. The third is an employer-financed IRA.

1. **Individual retirement accounts (IRAs).** A worker can make tax-deferred contributions to an IRA up to an annual limit of $2,000 ($2,250 for a single-earner married couple). However, if an individual is already covered under an employer-sponsored plan and has an adjusted gross income in excess of $25,000 ($40,000 for a married couple), the tax deduction is scaled down, reaching zero at an income level $10,000 over the threshold.
2. **Individual retirement annuities.** This is an annuity purchased from a life insurance company; as with the IRA, the insurer cannot accept more than $2,000 annually in premiums.
3. **Simplified employee pensions (SEPs).** An employer establishes and finances an IRA for each eligible employee. The contribution limit is much higher than for an IRA: the lesser of $30,000 or 15 percent of employee compensation. Compared with conventional pension plans, SEPs are easy and inexpensive to establish and are therefore favored by many employers.

TAX-DEFERRED ANNUITIES UNDER SECTION 403(B)

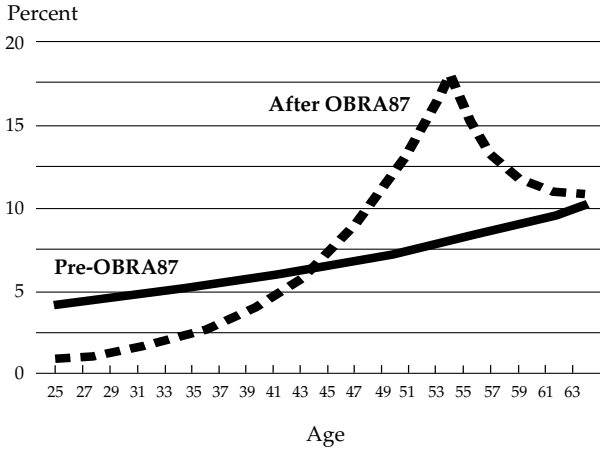
Section 403(b) plans are made available for nonprofit organizations and educational institutions. They are similar to 401(k) plans in that employees and/or employers may contribute pretax dollars to an investment pool. There are two limits on combined employer and employee annual contributions: (1) the lesser of 25 percent of taxable compensation or $30,000, or (2) a cumulative maximum exclusion allowance limit of 20 percent of taxable compensation times years of service minus prior contributions. There is also a limit on tax-deferred employee contributions similar to that of 401(k) plans ($9,500 in 1994).

quent indexing of these amounts in the years since, the following annual limits applied in 1994:

- Benefits from a defined benefit plan: the lesser of $118,800 or 100 percent of average compensation for the three consecutive years of highest earnings. A plan that provides for benefits in excess of this amount is disqualified.
- Contributions for a defined benefit plan are subject to a funding limit of 150 percent of termination liability. Excess funding is subject to a 10 percent excise tax.
- Contributions to a defined contribution plan: the lesser of $30,000 or 25 percent of the individual's compensation. Excess contributions are subject to a 10 percent excise tax.[9]
- Contributions by individuals to a 401(k): $9,240.

Figure 25

Projected Lifetime Contributions as a Percent of Salary for 25-Year-Old Participant



SOURCE: The Wyatt Company.

Table 6

Effects of OBRA87 Full-Funding Limits on Contribution Rates

Age	Worker Pay	Projected Unit Credit Contribution Rate	Contribution Rates Under Funding Limit of 150% of Accrued Benefit — Age When Change Implemented: 25	35	45	55
25	$25,000	4.2%	0.9%	4.2%	4.2%	4.2%
30	32,674	4.7	1.4	4.7	4.7	4.7
35	42,704	5.3	2.6	0.0	5.3	5.3
40	55,812	5.9	4.4	0.0	5.9	5.9
45	72,944	6.7	7.4	7.4	0.0	6.7
50	95,335	7.5	12.3	12.3	0.0	7.5
55	124,599	8.4	16.2	16.2	16.2	0.0
60	162,846	9.5	11.5	11.5	11.5	10.2
64	201,737	10.4	11.1	11.1	11.1	10.7

SOURCE: The Wyatt Company.

- Distributions from defined contribution plans are subject to the overall limit on benefits from one or several plans: a 15 percent excise tax on aggregate distributions received by an individual from one or more plans in excess of $148,500.[10]

The data indicate that although the vast majority (86 percent in 1987) of 401(k) plans are primary plans (i.e., the firm's sole or principal pension plan), aggregate participation in secondary 401(k) plans is substantially higher (49 percent of participants versus 26 percent in primary plans).[11] This suggests that small firms are much more reliant on 401(k) plans as their principal retirement saving plan.

The regulations described above tend to have two effects: (1) They reduce pension contributions and saving. (2) Because a substantial impact is felt by managers of businesses, who generally make the decision whether or not firms operate a pension plan, the regulations frequently lead to the abandonment of some plans and discourage the formation of new ones, particularly for small firms. CED believes that there are legitimate reasons to limit the pension tax preference received by any one individual. But the limitations just described, together with the limits on considered compensation, are duplicative, discourage investment in high-yielding assets, and are too damaging to the basic pension policy objective of encouraging retirement saving. Therefore, **CED urges Congress to eliminate the excise tax on distributions above the stated limit. Limits on benefits from qualified defined benefit plans, which discourage retirement saving and encourage investment in lower-yielding assets, should be increased. Contributions for qualified defined contribution plans should also be raised to more reasonable levels (and indexed for inflation) in order to encourage small-business managers to provide pension plans for all employees.**

CED also believes that individual contributions to 401(k) plans that are *primary* pension plans should be subject to the same limit that applies to other defined contribution plans, such that the combined employee and employer contributions do not exceed that limit. This will give workers in smaller firms an opportunity to expand their retirement savings and will provide a greater incentive for managers of small firms to offer these plans to their workers.

The contributions of all workers are also limited by discontinuities in employment and earnings. As we discussed in Chapter 3, pension plan participation is substantially lower among workers who are younger and have lower earnings (see Figures 20 and 21, page 30). Many of these workers are not offered a pension plan by their employers. Others do not have sufficient means to begin saving for their retirement, or they do not give saving for retirement a high priority because they are far from the end of their working lives. They permanently lose tax benefits available for pension saving during their younger years, and compounding of pension contributions and interest cannot occur over a long-enough period of years to build sufficient retirement income. **CED believes that it would be more equitable and a stimulus to saving if the retirement-saving tax preference were based on accumulated lifetime income. This would enable parents, who often must leave the labor force temporarily to care for children, and other individuals who undercontribute to their pension plans early in their careers to exceed the contribution limit in later years.** In practice, this would allow individuals to make larger tax-deferred contributions when they are financially better equipped to do so, usually later in their careers.[12]

Reductions in Considered Compensation Limits. In addition to the dollar limit on contributions, pension contributions for both defined benefit and defined contribution plans have been reduced by limits on considered compensation, which is the maximum amount of income that may be taken into account when calculating the eligible contributions for a defined contribution plan or the benefits

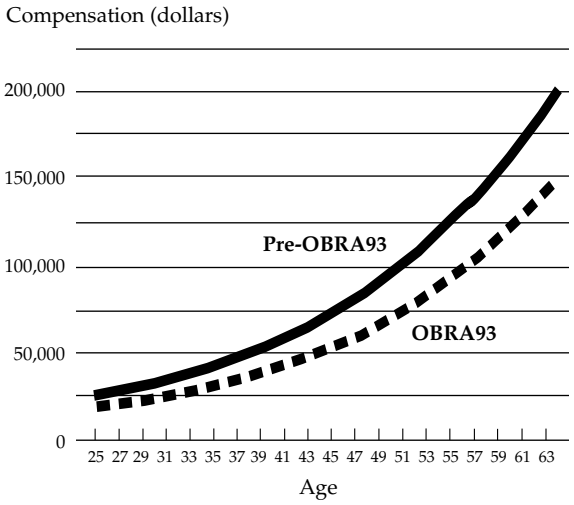
under a defined benefit plan. Although the intent may have been to limit contributions made for highly compensated individuals, in practice these limits are expected to have a substantial effect on contributions for lower-income workers. The Tax Reform Act of 1986 reduced the maximum from $235,000 to $200,000, and the Omnibus Budget Reconciliation Act of 1993 (OBRA93) reduced it further, to $150,000.[13] The most obvious effect of the rule is to reduce the pension contributions and benefits for highly compensated employees.[14] However, the lower limit on considered compensation can also severely limit contributions to defined benefit plans for individuals with low incomes but whose *projected* earnings exceed $150,000. The easiest way to see this is by examining Figure 26, which illustrates how the limit on considered compensation could affect the contributions for employee earnings of less than $20,000. Lowering the cap on considered compensation also affects middle- and lower-income workers participating in *defined contribution plans*, such as 401(k) plans, because it increases the likelihood of a plan failing to comply with nondiscrimination rules peculiar to these plans. Plan administrators must divide participating employees into two groups: highly compensated and all others. A plan is consid-

Figure 26

Considered Compensation Limits May Affect Non-Highly Compensated Employees

The chart shown illustrates how the $150,000 limit on considered compensation may affect contributions of employees with less than $150,000 of current income but whose projected earnings exceed $150,000. The solid line represents the lifetime projected compensation path for the same individual as in Table 6. The dashed line represents the OBRA93 earnings path for purposes of calculating his pension benefit. This line is derived by taking $150,000, the maximum allowable, and discounting back to year 1 at 5.5 percent a year (the same interest rate as the salary growth assumption). This gives a compensation figure of $18,589. Thus, instead of a benefit based on a percentage of $25,000, this individual's benefit is funded as a percentage of $18,589. The vertical distance between the two lines at every point represents the amount of reduction in considered compensation for each age. An important qualifier is that the $150,000 is indexed for inflation, which will allow employers to increase contributions over time and leave the ultimate benefit payment to the employee unaffected. However, as with the OBRA87 full-funding rule, delay of funding in the early years increases the burden in later years and increases the chances that employers will be unable or unwilling to continue to fund their pension plans.

Effect of Considered Compensation Limit at Each Age for Participant in Defined Benefit Plan



NOTE: Assumes individual enters service at age 25 earning $25,000 a year and expects annual salary growth of 5.5%.

ered nondiscriminatory only if elective contributions for the highly paid group do not exceed those for the lower-paid group by an amount determined by two alternative formulas.[15] For high-wage workers already contributing the maximum allowable to their 401(k) plans ($9,240 in 1994), reducing the considered compensation limit automatically increases the ratio of contributions to compensation and thus increases the likelihood that plans will fail the nondiscrimination test. Rebalancing contributions among high-wage employees in order to correct this problem is expected to result in reduced contributions for middle-income employees unfortunate enough to be just above the cut between the highly compensated and nonhighly compensated groups.

The primary purpose of the pension limitations in OBRA93 was to raise federal revenue. Advocates of considered compensation limits believed that such limits would prevent discrimination in favor of key employees. But clearly this objective will be undermined as some plans are abandoned, as some plan formulas are amended to negate the effects of the provision, and as lost benefits are recouped by other forms of payment. **CED urges Congress to discontinue the recent practice of reducing considered compensation as a means of raising federal revenue. We believe this practice is harmful because it can affect pension saving by reducing contributions for lower-income employees. It also reduces the willingness and ability of sponsors to create and maintain qualified plans.**

Assuming the elimination of the excise tax on distributions and increased limits on benefits as recommended by CED, we believe that some limits on considered compensation should be retained. However, the considered compensation limit should be raised to a more reasonable level, at least to its pre-OBRA93 level (and indexed); it should apply only to those whose incomes actually equal or exceed that limit, not to those whose *projected* incomes equal or exceed it.

CED also believes that the nondiscrimination tests under Sections 401(k) and 401(m) are unnecessarily complicated and reduce pension saving among middle-income earners as well as among more highly compensated employees. These tests could be eliminated and replaced by a vastly more simple and administratively inexpensive safeguard against discrimination. For example, employers who make contributions to 401(k) accounts could be required to contribute the same percentage of payroll for *all* participants up to the maximum contribution limit.[16]

REGULATIONS TO PREVENT DISCRIMINATION IN PENSION PLANS

The limit on considered compensation and limits on maximum benefits and contributions directly reduce pension saving. There are also nondiscrimination rules that are extremely costly to administer and have more subtle effects on pension saving. Generally, nondiscrimination rules provide for some *rebalancing* of pension benefits and contributions between high- and low-salary individuals. These rules are often expressed as percentages by which the contributions and benefits of high-salary workers cannot exceed those of low-salary workers. Falling into this category are the discrimination tests for 401(k) plans, Social Security integration rules, coverage rules, and top-heavy rules. These rules are extremely complicated, often redundant, and impose enormous costs on pension administration.

CED believes that these rules should be streamlined and simplified in a manner that reduces costs. Ideally, all discrimination tests would be replaced by a vastly more simple and less costly safeguard against discrimination. For example, **all employees who meet nondiscriminatory age and service eligibility requirements should be covered and receive the same ratio of contributions to wages up to the prescribed limit. (In the case of defined benefit plans, the same benefit**

formula should be applied.) If such a radical reform could not be adopted in its entirety, simplification should proceed along the lines described in this section.

TOP-HEAVY RULES

Top-heavy rules, a product of TEFRA, are a special set of particularly stringent nondiscrimination standards that must be met by plans in which 60 percent or more of accumulated benefits accrue to key employees (certain officers and highly paid employees). They include minimum benefits for nonkey employees in defined benefit plans, minimum contributions for employees in defined contribution plans, a complete prohibition against Social Security integration, and a faster vesting schedule (see the Appendix). The rules are costly to administer because they involve annual testing of *all* plans. They also reduce pension benefits for more highly compensated employees. Consequently, many top-heavy plans (primarily smaller ones) were abandoned after passage of the regulations.

The Tax Reform Act of 1986 subsequently strengthened nondiscrimination rules for all pension plans by enacting more stringent coverage and participation rules and requiring more rapid vesting of benefits. In light of these requirements, the special rules for top-heavy plans serve little useful purpose. **CED believes that the other nondiscrimination rules applying to all pension plans are adequate and that it is desirable therefore to completely eliminate top-heavy rules.**

SOCIAL SECURITY INTEGRATION

Because contributions and benefits under OASDI are greater for lower-salary workers, it has been a common practice in private pension plans to compensate for this distributional effect by weighting pension contributions and benefits toward the higher-salaried employees. The desired outcome was that either the combined contributions or the combined benefits accruing from Social Security and the private pension would equal approximately the same percentage of compensation for all employees.

The Tax Reform Act of 1986 introduced new rules that restricted the degree to which employers could integrate plans with Social Security. Essentially, it stipulated percentages by which benefits and contributions with respect to compensation above the Social Security taxable wage base could not exceed those with respect to compensation below the Social Security taxable base (see the Appendix for details). Because of these limits, many firms have had to restrict contributions to highly compensated employees.[17] **CED believes that restrictions on the integration of Social Security and private pensions are not needed in cases where the employer contribution for all employees equals or exceeds an appropriate minimum threshold.**

COVERAGE AND VESTING RULES

The Tax Reform Act of 1986 also introduced highly complicated nondiscrimination tests relating to coverage and vesting in defined benefit and defined contribution plans.[18] These rules are in addition to the stringent participation and vesting rules for individual employees.[19] Provided they are not too complex, rules that broaden coverage and accelerate vesting are generally desirable because they encourage the growth of pension saving. At present, however, these rules are excessively complex.

There are two primary effects of the coverage rules: (1) They make pensions complex and costly to administer because of the nature of the calculations involved. (2) They tend to redistribute benefits from high- to low-salary employees rather than simply increasing benefits for the low-salaried (and therefore total pension saving).

CED believes the current coverage rules are not cost-effective and should be simplified into a single test. For example, the rule could state that all employees who meet nondiscriminatory eligibility requirements must

be covered. Moreover, employers who provide a uniform ratio of contributions to wages for all eligible employees should be given safe harbor from all further discrimination tests.

CED also recommends that minimum vesting requirements be revised for recognition of the greater mobility of today's labor force. For example, vesting could be conferred on one of the following two schedules: (1) a three-year cliff (down from five) or (2) five-year graded (down from seven).

PRESERVING PENSION FUNDS FOR RETIREMENT

PRERETIREMENT LUMP-SUM WITHDRAWALS AND BORROWING FROM PENSIONS

As we noted in Chapter 2, many observers are greatly concerned that lump-sum preretirement withdrawals are often not being rolled over when participants change jobs. There is also concern about borrowing from pension funds. It is feared that both these practices place the economic security of future retirees in jeopardy. It is also argued that they are an abuse of tax preferences provided to encourage pension saving. Other observers fear that prohibition of these practices will discourage participation and pension saving, especially when applied to supplementary saving plans that typically involve voluntary employee contributions. However, CED believes that preretirement withdrawals and borrowing from pensions pose an even greater threat to pension saving and conflict with the basic objectives of pension policy.

CED recommends that in-service preretirement withdrawals and borrowing of *employer* contributions to pension plans be prohibited. Preretirement withdrawals and borrowing of voluntary *employee* contributions to pension plans should not be prohibited, but existing penalties should be retained.

PORTABILITY OF PENSIONS

Previously enacted reforms involving vesting in retirement plans and proposals for further improvements in pension coverage will help preserve pension funds for retirement. A needed improvement in pensions relating to preservation of funds for retirement involves the portability of defined benefit plans and the rollover of pension distributions when workers change jobs. **CED recommends that regulators investigate options for improving the portability of vested benefits from defined benefit plans. Individuals who change employers should be strongly encouraged to roll over preretirement lump-sum distributions into alternative retirement saving instruments such as individual retirement accounts (IRAs) and defined contribution plans maintained by their new employers.**

PENSION BENEFIT GUARANTY CORPORATION

According to the PBGC's 1993 annual report, its liabilities for payment of benefits to participants of terminated plans exceeded its assets by $2.9 billion. The six-year period that ended in 1993 saw an alarming trend: Although the number of plan terminations fell sharply compared with those in the preceding six years, the net claims of these plans on the PBGC (plan liability minus the sum of plan assets and recoveries from employers) rose from $1.7 billion (between 1982 and 1987) to $2.4 billion (between 1988 and 1993).

Unfortunately, there is a strong likelihood that the $2.9 billion is just the tip of the iceberg. The PBGC has developed three alternative forecasts of future losses. The most optimistic of these forecasts projects a deficit of $1.9 billion (in 1993 dollars) by the end of 2003, but it assumes a continuation of the same average annual net losses the agency has incurred over its entire lifetime. On the other hand, if companies in a precarious financial state, whose plans are classified by the PBGC

as "reasonably possible losses," actually terminate their plans, the PBGC expects a deficit of $13.8 billion by 2003.[20] In this scenario, the possibility of a taxpayer bailout looms ominously.

Although the true financial condition of the PBGC is reflected in a comparison of its assets and the present value of its liabilities, the relevant comparison for federal budgeting is between current-year income and expenses; in this case, the PBGC now has a surplus. Thus, the PBGC actually contributes to reducing the budget deficit, which in turn reduces the incentive for Congress to focus on the underlying long-term problem. However, a change in the way that the PBGC's activities are accounted for in the federal budget from an operating-income basis to a change-in-net-liability basis would help to get the attention of Congress because it would then be adding to the deficit.

There are three underlying causes of the PBGC's dire financial straits: (1) Premium levels are not set to cover future claims adequately. (2) Premiums are structured in a way that creates an adverse-selection problem in the insurance pool. (3) Companies that underfund their plans have insufficient incentive to increase funding, because of weak PBGC compliance authority. Moreover, minimum- funding requirements under current law allow companies to amortize certain kinds of unfunded liabilities, including those that arise because of an increase in promised benefits, over a long period of time.[21]

THE PREMIUM STRUCTURE

Until passage of the Retirement Protection Act of 1994 (incorporated in the GATT-enabling legislation; see the Appendix), plans paid $19 a year per participant, plus $9 for each $1,000 of unfunded vested benefits. There was an overall cap of $72 per plan participant. The sum of these premiums and the income earned from investing them, plus recoveries from employers in the event of plan termination, were supposed to fund the PBGC's liabilities. The 1994 legislation phases out the cap on the variable part of the premium over three years. This reform still does not permit premiums to be set in a way that satisfies insurance market principles.

In a private insurance market, premiums would be set for each plan according to two criteria:

1. The statistical probability of plan failure, which in turn is dependent on the firm's financial condition and future prospects.
2. The amount of the insurer's exposure in the event of plan termination. This is represented by the unfunded actuarial liability minus employer liability payments.[22]

Although phasing out the variable premium cap is a move toward risk-based premiums, the current PBGC premium structure is still deficient in two respects:

1. It does not reflect the likelihood of plan failure. A number of the companies whose pension plans are most underfunded are nevertheless in sound financial condition and expose the PBGC to relatively little risk.
2. Although the variable part of the premium is now more closely related to underfunding, it does not distinguish between plans on the basis of asset risk.[23]

Because of these shortcomings in the premium structure, some underfunded plans are, in effect, being subsidized by healthy ones. Consequently, the companies that sponsor weaker plans have an incentive to stay in the system, and those that sponsor stronger ones have an incentive to terminate them. Moreover, there is a clear danger that raising premiums to a level that would cover the PBGC for its expected losses would further exacerbate the adverse selection problem by causing strong firms to terminate their plans and withdraw from the insurance pool.[24]

MORAL HAZARD

The PBGC does not have sufficient authority to enforce responsible behavior by pension plan sponsors whose actions expose the agency to loss. Thus, firms in a precarious financial position have an incentive to garner additional resources by reducing pension contributions. They are also likely to embark on riskier investment strategies. Moreover, such firms have an incentive to offer pension benefits that are insured by the PBGC and whose funding is deferrable in lieu of wage compensation. Workers accept such arrangements because the PBGC protects them from loss. It is for these reasons that unfunded plan liabilities tend to rise sharply in the period just prior to plan termination (usually when the firm is bankrupt), thus increasing the PBGC's exposure. In the words of the PBGC's own annual report:

> The insurance program's weakness creates incentives for financially distressed companies to take actions that further increase the program's exposure to loss. Such actions include:
>
> - using pension increases as a form of compensation, the costs of which can be deferred. Workers are more willing to agree to these promises because they are backed by federal pension insurance. . . .
> - forgoing required pension contributions while in bankruptcy with judges' approval. . . .
> - allowing a pension plan to run out of money without violating the minimum funding standards. . . .

Lenders rarely put pressure on troubled companies to fund their plans, believing in the optimistic funding assumptions and expecting the PBGC's pension claims will have no priority. On the contrary, creditors are more likely to pressure distressed companies to terminate plans rather than fund them.[25]

It is no longer possible, as it was prior to 1986, to terminate an underfunded pension plan and pass the liability on to the PBGC without demonstrating financial distress. Moreover, the PBGC now has claim to 100 percent of unfunded liabilities from plan sponsors. Although these changes have ameliorated the problem of moral hazard, they have by no means eliminated it. Bankrupt companies frequently do not have sizable assets for the PBGC to seize; and in any case, the PBGC claim is not necessarily given priority above those of other creditors. The data indicate that liability payments from employers to the PBGC have actually dropped slightly as a percentage of uncovered benefit liabilities since the new rules were passed.

CED recommends the following reforms:

- **The PBGC insurance premium should be restructured so that it more closely resembles what would be offered in a private market. Such a redesign should include a stronger linkage between the premium level and the actual risk posed by a pension plan to the PBGC. For example, the premium calculation could take into account the financial strength of the plan sponsor, the marketability of plan assets, and the proportion of assets tied up in the firm's own equities.**
- **The PBGC should be given more power to influence the behavior of sponsors of underfunded plans, including the authority to prevent plans operating below a particular funded ratio from granting benefit increases to employees.[26]**
- **The amortization schedules for unfunded liabilities should be simplified by reducing the number of categories, and the amortization periods should be shortened to accelerate the funding of liabilities.**
- **The PBGC's benefit guaranty structure should be revised to correlate more closely with the minimum funding requirements attributable to specific benefits, such as shutdown benefits.**
- **The status of the PBGC's claims in bankruptcy should be reviewed and enhanced as appropriate.**

RISING REGULATORY COSTS DISCOURAGE PENSION SAVING

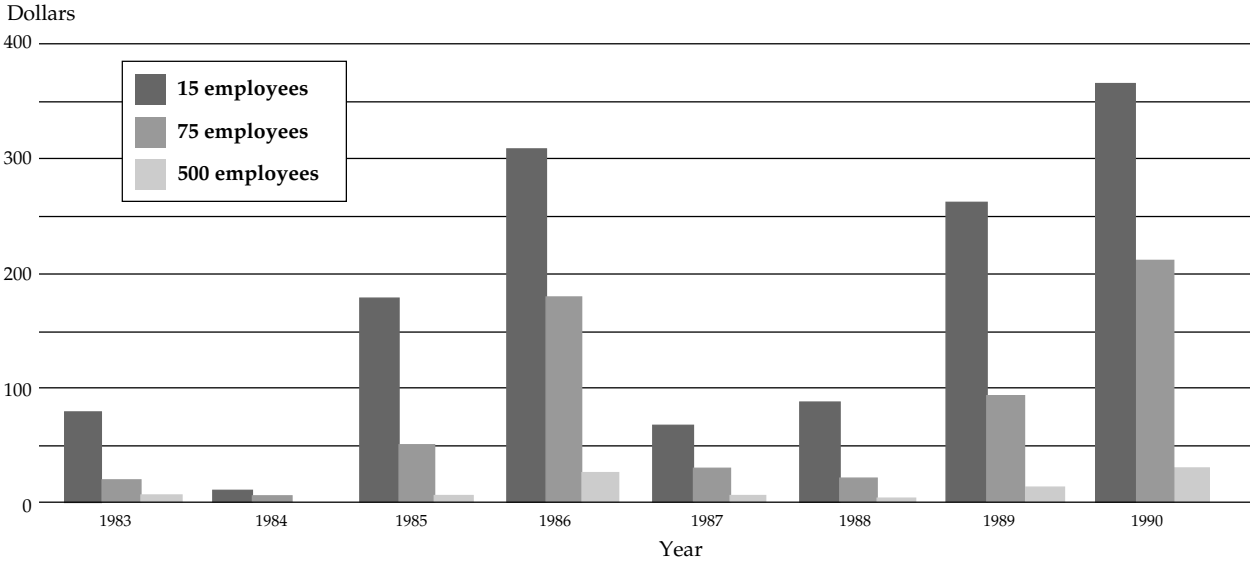
The number of defined benefit plans peaked at just over 175,000 in 1983 and subsequently declined by 24 percent in the 1984–1989 period. Of the net 43,000 defined benefit plans lost during that period, about 90 percent were plans servicing fewer than 100 workers. The Employee Benefit Research Institute reports that 60 percent of the net terminations between 1985 and 1989 had fewer than 10 participants.[27] There is no doubt that rising administrative costs, which are particularly burdensome for small employers, contributed significantly to the decimation of defined benefit plans in the 1980s.

A study by Hay/Huggins Company for the PBGC[28] analyzed the impact of eleven major regulatory changes, enacted between 1982 and 1989, on the cost of administering defined benefit and defined contribution plans of varying sizes. It found that real administrative costs for both the smallest and the largest defined benefit plans (covering 15 and 10,000 persons, respectively) increased at an average annual rate of more than 10 percent between 1982 and 1991, with costs for intermediate plan sizes increasing at a slightly lower rate. Small plans were particularly burdened by one-time expenditures arising from frequent changes in regulations (Figure 27). For the smallest plans, administrative costs *per covered employee* increased from $162 to $455 (in 1990 dollars), compared with an increase from $19 to $54 for large plans.[29] Equally telling is that by 1991, small-plan administrative costs were equal to about one-third of the benefits accrued in that year. In other words, for every $3 of retirement benefits accruing to participants, an extra $1 was being spent on administrative costs. For a large plan with 10,000 employees, administrative costs were estimated at just 4 percent of benefits.

According to the Hay/Huggins study, defined contribution plans fared slightly better under the constantly changing regulatory

Figure 27

One-Time Administrative Costs per Worker in Defined Benefit Plans, by Plan Size, 1983 to 1990 (in 1990 dollars)



SOURCE: Hay/Huggins Company, Inc.

regime; the increase in real administrative costs for these plans between 1982 and 1989 was in the 6 to 7 percent range, depending on plan size. More important, ongoing costs for the most severely affected defined contribution plans were still only half as large as those for small defined benefit plans. The results of direct interviews with fifty pension service providers, conducted for the Small Business Administration in 1989, indicated similar trends. Annual administrative costs for a small defined benefit plan were 50 percent higher than for a defined contribution plan of the same size and 270 percent higher on a per-participant basis than for a larger defined benefit plan.[30]

SOURCES OF COST INCREASES

According to the Hay/Huggins study, consulting fees for actuarial and legal services made up the bulk of the cost increases for small plans, whereas consulting fees and PBGC premiums were of equal importance in large plans. The consulting fees were paid to actuaries and lawyers who were needed repeatedly by plan sponsors to explain regulatory changes, redraw plan documents, test plans for discrimination, and calculate maximum and minimum contribution levels. These activities were accompanied by increases in in-house administrative costs for such purposes as collecting and preparing data and communicating plan changes to participants. The most costly legislative changes were identified as: Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Retirement Equity Act of 1984 (REA), Tax Reform Act of 1986 (TRA), Single Employer Pension Plan Amendments Act of 1986 (SEPPAA), and Omnibus Budget Reconciliation Act of 1987 (OBRA87). (See the Appendix for details.)

Although each regulatory change can be examined in isolation for the costs it imposed on pension plans, it is important to recognize that the sheer regularity of the changes has made it difficult (if not impossible) for smaller firms to stay in compliance with the law and to have any assurance of future stability. It is also important to note that there have been a number of regulatory changes since 1989 (the last year studied), which continue to impose a heavy administrative cost burden on pension plans.[31]

IMPACT OF COST INCREASES ON PLAN TERMINATIONS AND FORMATIONS

The costs of maintaining defined benefit plans have become too high for many employers, a fact that has contributed to their decision to terminate plans. In a survey conducted in 1992, 50 percent of the respondents stated that they terminated their defined benefit plans because federal regulations were "too costly or burdensome."[32] The data indicate that a large number of employers who terminated defined benefit plans did not replace them with successor pension plans of any kind, and most of those who did so opted for defined contribution plans.[33]

These trends indicate that it is critical that policy makers simplify and stabilize regulations pertaining to defined contribution plans in order to reduce compliance costs. The retirement security of the 40 million participants of defined benefit plans may depend to a significant degree on policy makers' actions that influence plan administrative costs.[34]

APPENDIX

A Brief History of Government Regulation of Private Pensions

Legislation governing private pension plans was only sporadic until passage of the Employee Retirement Income Security Act (ERISA) in 1974. Since then, however, pension law has been subject to incessant revision by Congress.

What follows is only a thumbnail sketch of the evolution of private pension regulation. However, it is sufficient to demonstrate how obsessively Congress has tinkered with the law and how complicated that law has become.

Before ERISA

1. *Revenue Act of 1921*. Deferred tax (until benefit disbursement) on contributions to, and income from, stock bonus or profit-sharing plans established for employees. The *Revenue Act of 1926* extended the concession to other pension plans.
2. *Revenue Act of 1938*. Denied tax-exempt status to any pension plan that revoked pension promises to its participants. This legislation responded to the problem of plans being terminated so that the funds could be used for purposes other than meeting pension obligations.
3. *Revenue Act of 1942*. Responded to concerns about discrimination against rank-and-file employees by establishing participation tests.
4. *Welfare and Pension Plans Disclosure Act of 1958*. Required pension plan documents and annual reports to be submitted to the Secretary of Labor and to plan participants. The objective was to make fraud and other maladministration of plans more easily detectable.
5. *Self-Employed Individual Retirement Act of 1962 (Keogh Act)*. Expanded tax-favored retirement plans to include unincorporated small business and the self-employed.

Employee Retirement Income Security Act of 1974 (ERISA)

1. Concerns addressed by legislation:

   a. Plans were exclusionary, with limits on participation and vesting of benefits.

   b. Some plans were inadequately funded to meet their obligations.

   c. There were insufficient incentives for some employers to offer pension plans.

   d. Some plans were not administered according to acceptable fiduciary standards.

   e. Pension benefits for key employees were sometimes viewed as excessive in relation to perceived retirement needs.

   f. Pensions were not always protected during takeovers or other kinds of company restructuring.

2. Major provisions:

   a. Required more *information* to be provided by employers to plan participants: an easily intelligible plan description, subsequent plan modifications, an annual financial report, and a statement of the participant's accrued benefits upon request. This strengthened the provisions of the 1958 disclosure act, which was formally repealed.

b. Strengthened *participation* rules. Required that employees 25-years-old and over with one year of service could not be excluded from a plan.[1]

c. Established *vesting* rules. Employers could choose one of three alternative formulas:

i. Full vesting after ten years with no vesting until then.

ii. Graded vesting, achieving 100 percent after fifteen years of service.[2]

iii. The "rule of 45": at least 50 percent vesting when the employee's age and years of service add to 45, increasing by 10 percent each succeeding year until full vesting is attained.[3]

d. Required that a *joint and survivor annuity* be provided to an employee retiring at the normal age unless the employee specifically waived that right.

e. Set *minimum funding* rules, by requiring that the normal cost of a pension plan be funded currently.[4] Past service costs were to be amortized over thirty or forty years.

f. Set *fiduciary standards*. Plan assets had to be invested prudently and for the sole benefit of plan participants. Relevant financial and participation data must be provided periodically to the government.

g. Allowed a person not covered by a pension plan to establish an *individual retirement account*. IRA contributions up to the lesser of $1,500 or 15 percent of earned income would be tax deductible.

h. *Limited contributions* to profit-sharing and money purchase plans[5] to the lesser of 25 percent of annual compensation or $25,000.

i. *Limited annual pension benefits* that could be paid to highly compensated employees to the lesser of $75,000 or 100 percent of average compensation for the three years of highest career earnings.

j. Established the *Pension Benefit Guaranty Corporation*. Purchase of insurance was made mandatory for most plans receiving tax concessions. The PBGC guaranteed payment of vested benefits to a certain level. The premium was set at $1 per plan participant.

Revenue Act of 1978

1. Contained incentives to encourage smaller firms to set up pension plans for their employees.

2. Major provisions:

a. Established *cash or deferred arrangements* (CODAs) by adding Section 401(k) to the Internal Revenue Code.[6]

b. Established *simplified employee pensions* (SEPs), in which the employer sets up and finances IRAs for eligible employees. However, the maximum contribution limit, $7,500, was higher than for IRAs.[7]

c. Created *tax-credit ESOPs*, or *TRASOPs*, a form of employee stock ownership plan whereby an employer could receive a tax credit equal to contributions.

Multiemployer Pension Plan Amendments Act of 1980 (MEPPAA)

1. This legislation was designed to address underfunding of multiemployer pension plans.

2. Major provisions:

a. Reduced the incentive for individual employers to withdraw from multiemployer plans by obliging them to continue funding the liability of workers they had hired in the past.

b. Increased PBGC premiums for multiemployer plans.

c. Required faster funding of unfunded liabilities.

Economic Recovery Tax Act of 1981 (ERTA)

1. Contained further incentives to increase pension saving:

   a. Replaced TRASOPs with *payroll-based ESOPs (PAYSOPS)*, whereby an employer received a tax credit equal to a percentage of payroll.

   b. Commercial lenders facilitating *leveraged ESOPs*[8] were allowed to deduct a portion of their interest income on these loans. This effectively lowered the cost of setting up an ESOP.

   c. Permitted *IRAs for all workers*, and raised the *contribution limit* from $1,500 to $2,000.

   d. Increased *limit on contributions to SEPs* from $7,500 to $15,000 per participant.

Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)

1. This legislation signaled a shift in pension policy away from concerns about pension security and the adequacy of retirement income toward measures to reduce tax revenue loss.

2. Major provisions:

   a. Reduced *contribution limits for defined contribution plans* to the lesser of 25 percent of compensation or $30,000.[9]

   b. Reduced *maximum annual pensions from defined benefit plans* from $136,425, to the lesser of 100 percent of average cash compensation in the three years of highest earnings or $90,000.

   c. For *defined contribution plans integrated with Social Security*, contributions based on that part of income *above* the Social Security taxable wage base (the so-called *integration level* or *breakpoint*) could not exceed contributions in respect of income *below* (the *base contribution percentage*) by more than 5.4 percent.[10]

   d. Introduced *top-heavy rules*. A top-heavy plan was defined as one in which 60 percent of accumulated benefits had accrued to key employees (officers and highly compensated employees). Top-heavy plans had to comply with special standards for vesting, contributions and benefits, and Social Security integration.[11]

Deficit Reduction Act of 1984 (DEFRA)

1. Major provision:

   a. Delayed *indexing of contribution and benefit limits* until 1988.

Retirement Equity Act of 1984 (REA)

1. Major provisions:

   a. Strengthened *participation rules* by lowering the minimum age a firm can require for enrollment in a plan from 25 to 21; the law also lowered the minimum age for vesting service from 22 to 18.

   b. An employee could now have a *break in service* of up to five consecutive years or the period of eligibility or vesting service accumulated prior to the break without losing that eligibility or vesting service. Maternity and paternity leaves were to be treated as though the employee was still at work through the period of absence.

   c. Greater *survivor protection*:

      i. Preretirement death benefit was extended to all vested employees.

      ii. Written spousal consent was required to exclude death benefits in order to obtain a more generous pension.

      iii. On some domestic relations orders, private pensions could be divided upon divorce.

Single Employer Pension Plan Amendments Act of 1986 (SEPPAA)

1. Congress enacted SEPPAA largely because of the moral hazard implicit in the pension

insurance system, whereby under existing law, it was possible for a firm to terminate a pension plan and shift the unfunded liabilities onto the PBGC.

2. Major provisions:

a. Raised *PBGC premium*.

b. Limited the circumstances under which a *voluntary plan termination* could occur:

i. Standard termination: A voluntary termination in which liabilities were covered by assets.

ii. Distressed termination: Permitted at the discretion of the PBGC. Required the plan administrator to show that the firm was financially unable to continue the plan.[12]

Tax Reform Act of 1986 (TRA)

1. Major provisions:

a. The minimum *vesting* requirement was now defined by the following two options:

i. Five-year cliff.

ii. Graded, under which participants are 20 percent vested after three years, with an additional 20 percent each subsequent year until full vesting is attained after seven years.

b. Where plan *vesting* was 100 percent upon enrollment, an employer could now require only *two* years of service before enrolling an employee.

c. Instituted a 10 percent *tax penalty* on distributions made prior to age 59 1/2.

d. Established a 10 percent *excise tax on excess pension assets* that reverted to the employer upon termination of a pension plan.

e. For participants in employer-sponsored pension plans whose adjusted gross income was greater than $25,000 ($40,000 for a married couple filing jointly), pretax *IRA contributions* were phased out.

f. Limited the amount of *compensation that could be considered* in contribution or benefit calculations to $200,000, the same as for top-heavy plans.

g. Temporarily capped *contributions to defined contribution plans* at $30,000.

h. Reduced the limit on employee contributions to *401(k) plans* from $30,000 to $7,000.

i. Changed rules for *integration* of plans with Social Security:

i. For a defined contribution plan, contributions in respect of compensation *above* the integration level could not exceed the base contribution percentage by more than the lesser of the base contribution percentage or 5.7 percent.

ii. For a defined benefit *excess* plan,[13] the excess benefit percentage could not exceed the base percentage by more than the lesser of the base benefit percentage or 0.75 percent.[14]

iii. For a defined benefit *offset* plan,[15] the maximum offset could not exceed the lesser of 50 percent of the benefit accrued without regard to the offset or 0.75 percent of final-average compensation multiplied by years of service.

j. New *coverage* rules were introduced. One of three tests now had to be satisfied:

i. Percentage test: The plan must cover at least 70 percent of all non–highly compensated employees.[16]

ii. Ratio test: The percentage of non–highly compensated employees covered under a plan must be at least 70 percent of the percentage of highly compensated employees covered.

iii. Average benefits percentage test: Both of the following must be satisfied to pass this test:

(a) The plan must cover a non–discriminatory classification of employees.[17]

(b) The ratio of employer-provided benefits or contributions to the participant's compensation for non–highly compensated employees must be at least 70 percent that of highly compensated employees.

k. A new *nondiscrimination* rule was introduced for 401(k) plans. The average ratio of contributions to compensation of the highly compensated group cannot exceed:

i. 125 percent of the ratio of the rank-and-file group if the ratio for the latter group is 8 percent or more.

ii. 200 percent of the ratio of the rank-and-file group if the ratio for the latter is 2 percent or less.

iii. 2 percent in all other cases.

l. Profit-sharing plans could no longer apply the unused portion of their prior-year contribution limit (15 percent of the cash compensation of plan participants) to exceed their contribution limit in another year.

Omnibus Budget Reconciliation Act of 1986

1. Major provisions:

a. Benefit accruals could no longer be frozen beyond normal retirement age.

b. Employees hired after age 60 could no longer be excluded from participation.

Omnibus Budget Reconciliation Act of 1987 (OBRA87)

1. Major provisions:

a. Increased the *PBGC premium* from $8.50 to $16 per participant, plus an additional premium of $6 per $1,000 of unfunded liability (although the premium was capped at $50 per participant).

b. Introduced *quarterly contribution requirements*.

c. The *period for amortizing* experience gains and losses was reduced from fifteen to five years.

d. Introduced a new *minimum contribution standard* for underfunded defined benefit plans with more than 100 participants. The minimum contribution may henceforth include a "deficit reduction contribution" that would effectively speed up the funding of underfunded plans.[18]

e. The *full-funding limitation* for defined benefit plans was capped at 150 percent of termination liabilities. As a consequence of rising asset values, many firms were unable to make further deductible contributions.

Technical and Miscellaneous Revenue Act of 1988 (TAMRA)

1. Major provision:

a. Increased the *excise tax* on employer reversion of assets from 10 percent to 15 percent.

Omnibus Budget Reconciliation Act of 1989 (OBRA89)

1. Major provision:

a. Defined benefit *plan valuations* would now be required annually instead of triennially.

Omnibus Budget Reconciliation Act of 1990 (OBRA90)

1. Major provision:

a. Enabled employers to transfer excess pension assets tax-free to an account for the current health benefit expenses of retirees. Otherwise, the excise tax on asset reversions increased to 20 percent or 50 percent unless the employer transferred a portion of the assets to a replacement plan or increased benefits under the terminating plan.

Omnibus Budget Reconciliation Act of 1993 (OBRA93)

1. Major provision:

a. Reduced *considered compensation* from $235,840 to $150,000.

Retirement Protection Act of 1994 (RPA, incorporated in Uruguay Round Agreements Act)

1. The Retirement Protection Act accelerated funding of the liabilities of underfunded pension plans and contained other measures that strengthened the position of the PBGC. The net effect of RPA on government revenues is positive; consequently, it was incorporated as part of the financing package for the General Agreement on Tariffs and Trade (GATT).

2. Major provisions:

a. Delayed indexation of *dollar limits on contributions and benefits* by stipulating that inflation adjustments be implemented in round dollar amounts, rather than annually in step with the precise rate of inflation. Indexation will now occur in the following increments:

i. Benefit limit for a defined benefit plan: $5,000.

ii. Contribution limit for a defined contribution plan: $5,000.

iii. Limit on elective deferrals under a 401(k) plan: $500.

b. Strengthened *minimum funding standards* for underfunded defined benefit plans:

i. Increased the required contribution for unfunded new liability.

ii. Provided for accelerated funding of *unpredictable contingent event benefits*.[19]

iii. Lowered the maximum interest rate that could be used for calculating plan liability to 105 percent of the weighted average of thirty-year Treasury securities, for the four most recent years prior to the plan year.[20]

iv. Mandated use of the 1983 Group Annuity Mortality Table for determination of current plan liability.[21]

c. Prohibited certain underfunded plans from changing actuarial assumptions for determining current liability without first gaining approval of the Secretary of the Treasury.

d. Prohibited an employer in bankruptcy from amending an underfunded plan to increase benefits unless the increase became effective after the planned date of the firm's reorganization.

e. Authorized the PBGC to obtain certain information from sponsors of underfunded plans that would assist the PBGC in determining plan assets and liabilities.

f. Gave the PBGC authority to sue plan sponsors to enforce minimum-funding requirements where the amount of the deficient contributions exceeds $1 million.

g. Phased out, over three years, the cap on the variable part of the PBGC premium.

h. Required employers who pay the variable premium to notify plan participants of the plan's funded status and the extent of the PBGC's guaranty in the event of plan termination.

NOTES

CHAPTER 1

1. The *baby-boom generation* refers to the bulge in the age distribution caused by a rise in birthrates between 1946 and 1964 and the decline thereafter. The earliest baby boomers will reach 65 in 2011, but they will affect the retirement-age population much earlier because many workers retire before the age of 65.

2. B. Douglas Bernheim, "Is the Baby Boom Generation Preparing Adequately for Retirement?" Technical Report, mimeographed, 1992, and a "Summary Report" with the same title published by Merrill Lynch, 1993.

3. The ratio is expected to remain at that level or one slightly lower through to 2070.

4. Information supplied by the Office of Management and Budget.

5. Hospital insurance includes only Part A of Medicare. Under current policies, the HI program is expected to realize a $7 billion cash-flow deficit in calendar 1994, increasing to $1.2 trillion in 2030. See U.S. Department of Health and Human Services, Social Security Administration, *Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, 1994* (Washington, D.C.: U.S. Government Printing Office, 1994), and the U.S. Department of Health and Human Services, Health Care Financing Administration, *Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund, 1994* (Washington, D.C.: U.S. Government Printing Office, 1994).

6. Although the Social Security projection includes the increase in the normal retirement age enacted earlier, currently legislated benefits are assumed to be unchanged.

7. Currently, about three-quarters of SMI funding comes from general tax revenues and one-quarter from enrollees. SMI is expected to grow to be as large as HI. C. Eugene Steuerle and Jon M. Bakija, *Retooling Social Security for the 21st Century: Right and Wrong Approaches to Reform* (Washington, D.C.: The Urban Institute Press, 1994), pp. 54-55.

8. The full commission did not accept the Kerrey-Danforth proposals, of which the four most important in relation to Social Security were: (1) further increasing the Social Security retirement age, (2) reducing growth of initial benefits relative to earnings, (3) reducing benefits for upper-income workers, and (4) replacing part of the Social Security program with a mandatory saving program. The leadership of the 104th Congress has also indicated that no changes will be made to Social Security for the time being.

9. Defined benefit plans promise a specific benefit; defined contribution plans promise a specific contribution to a fund. The benefits provided by defined benefit plans are normally determined by a formula relating to compensation and length of service. Benefits from a defined contribution plan depend on the annuity value of the total accumulation.

10. Pension Benefit Guaranty Corporation, news release, December 5, 1994.

11. The PBGC insures individual benefits promised by 66,000 private defined benefit plans up to $30,886 (adjusted annually for inflation). Although it charges plan sponsors a premium for the insurance, the premiums do not cover expected liability, which has risen rapidly. Reforms enacted as part of GATT-enabling legislation should help correct this situation over time. (See Chapter 5, page 48.) However, if underfunding of pension plans continues to grow rapidly as some anticipate, an eventual bailout by taxpayers cannot be ruled out.

12. Office of Management and Budget.

13. Merrill Lynch, *Retirement Savings in America* (Princeton, N.J.: Merrill Lynch, Pierce, Fenner & Smith, Inc., 1993).

14. Prior to OBRA93, the considered compensation limit was $235,840.

CHAPTER 2

1. The aging of the population is, in fact, a worldwide phenomenon; and old-age security systems, including both community- or family-based systems and formal retirement programs, appear to be breaking down in many countries. International Bank for Reconstruction and Development, *Averting the Old Age Crisis: Policies to Protect the Old* ***and*** *Promote Growth* (New York: Oxford University Press, 1994).

2. Employee Benefit Research Institute, *Baby Boomers in Retirement: What Are Their Prospects?*, Special Report and Issue Brief, no. 151 (Washington, D.C.: EBRI, July 1994), Table 12, page 19.

3. About 2.6 million federal workers and 11.3 million state and local government workers participate in these plans. EBRI, *Baby Boomers in Retirement: What Are Their Prospects?*, Table 12, page 19.

4. Although foreign capital inflows may provide considerable support for investment, they cannot be counted on to make up for the decline in domestic saving. Economic studies find that saving and investment rates are highly

correlated both across countries (which suggests that barriers to international capital flows are still important) and over time within individual countries. Martin S. Feldstein and Charles Horioka. "Domestic Saving and International Capital Flows" *Economic Journal* (June 1990). It has been estimated that it would take a national saving rate of 5 to 5.5 percent simply to maintain productivity growth at about 1 percent annually. See Charles L. Schultze, "Of Wolves, Termites, and Pussycats, or Why We Should Worry about the Deficit," *The Brookings Review* (Summer 1989): 33.

5. On a current-account basis, the U.S. net foreign investment position fell from a surplus of $234 billion in 1984 to a deficit of $591 billion in 1992, the latest year for which data are available. *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, February 1994), p. 385.

6. Some have speculated that the saving rate will rise sharply as the baby boomers age. But the decline in the personal saving rate does not appear to have occurred because of demographic change; therefore, the aging of the baby boomers may not increase the overall saving rate significantly. Martin Neil Baily, Gary Burtless, and Robert E. Litan, *Growth with Equity: Economic Policymaking for the Next Century* (Washington, D.C.: The Brookings Institution, 1994), p. 147.

7. See *Restoring Prosperity: Budget Choices for Economic Growth*, p. 6.

8. Congressional Budget Office, *An Economic and Budget Outlook Update* (Washington, D.C.: U.S. Government Printing Office, August 1994), p. 8. The standardized employment budget measure, which adjusts for the business cycle, suggests that nearly half of the deficit decline reflects a change in fiscal policy.

9. CBO, *An Economic and Budget Outlook Update*, p. 29.

10. A recent survey conducted by Merrill Lynch indicated that among those who are not self-employed, only 46 percent of those in the 45- to 64-year age bracket reported that they were saving specifically for retirement; among the baby-boom generation, only 25 percent indicated that they were currently saving for retirement. See Merrill Lynch, *Retirement Savings in America* (Princeton, N.J.: Merrill Lynch, Pierce, Fenner & Smith, Inc., 1993). Based on a telephone survey of workers who are not self-employed, p. 3. Surveys conducted in 1993 and 1994 by the Gallup Organization for the Employee Benefit Research Institute found that two-thirds of respondents who had not retired had begun to save for their retirement, although the amounts actually being saved appear to be quite inadequate. See Employee Benefit Research Institute, *Public Attitudes on Retirement Income, 1994*, Report no. G-55 (Washington, D.C.: EBRI, 1994); and EBRI, *Public Attitudes on Retirement Age and Planning, 1993*, Report no. G-46 (Washington, D.C.: EBRI, 1993).

11. These policy changes are described in Chapter 5. Other factors that may have contributed to the decline in business contributions include the rising costs of health care programs, the growing importance of small firms that often have no (or less generous) pension plans, and the rising value of assets in pension portfolios.

12. This increase in the normal retirement age, enacted in the early 1980s, was intended to compensate for the rise in life expectancy from that time until 2025 but not the growth in life spans before or after. C. Eugene Steuerle and Jon M. Bakija, *Retooling Social Security for the 21st Century: Right and Wrong Approaches to Reform* (Washington, D.C.: The Urban Institute Press, 1994), pp. 195-198.

13. The current Social Security offset rules are as follows: (1) for those under 65, benefits are reduced $1 for every $2 of annual earnings in excess of $8,040; (2) for those 65 to 69 years old, benefits are reduced $1 for every $3 of earnings in excess of $11,160; (3) for those over 69, no benefit reduction.

14. OBRA93 increased the percentage of Social Security benefits subject to tax for higher-income taxpayers. Social Security benefits for individuals with incomes below $25,000 ($32,000 for joint returns) are not taxable. For individuals with combined incomes between $25,000 and $34,000 ($33,000 and $44,000 for those filing jointly), 50 percent of benefits are taxed. The act made 85 percent of benefits subject to tax for those with higher incomes.

15. Merrill Lynch, *Retirement Savings in America*.

16. A recent survey of 1,000 adult Americans sponsored by Merrill Lynch found that 82 percent were unable to pass a basic financial literacy test; 55 percent were not able to correctly answer which of stocks, bonds, savings accounts, and CDs had generated the highest historical returns; 29 percent could not make a simple compound interest calculation; and 87 percent could not accurately estimate the maximum annual Social Security benefit. Using Merrill Lynch data, Professor B. Douglas Bernheim found a causal connection between substandard financial literacy and inadequate saving. See B. Douglas Bernheim, "The Determinants and Consequences of Financial Literacy," (manuscript, October 1994).

CHAPTER 3

1. These projections included 5.0 million recipients of disability in 1993; this number is expected to rise to 10.5 million by 2030. The projections assume that the fertility rate will decline from 2.07 in 1990 to 1.9 in 2020 and hold steady thereafter. (The fertility rate is the average number of children that would be born to a woman in her lifetime if she were to experience the birthrate prevailing in a particular year.) Life expectancy at birth is assumed to rise from about 75 years in 1990 to about 79 years in 2030. For details, see U.S. Department of Health and Human Services, Social Security Administration, *Annual Report*

of the Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, 1994 (Washington, D.C.: U.S. Government Printing Office, 1994), p. 59.

2. See Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds, 1994*, p. 119.

3. In addition to economic and demographic factors, the magnitude of the necessary payroll tax increase would depend on such factors as when that tax increase would be implemented and the size and rate of the drawdown of the surplus. The Social Security Administration calculated that the OASDI rate would have to be raised by 2.13 percentage points *beginning in 1994* in order to bring the program into actuarial balance over the seventy-five-year projection period (ending in 2068). (The pessimistic projection suggests a much larger tax increase.) However, it is unlikely that rates will be increased for this purpose until much later, perhaps until the surplus begins to run down. Thus, the realized increase is likely to be substantially higher than 2.13 percentage points. Social Security Administration, *Annual Report of the Board of Trustees of the Federal OASDI Trust Funds, 1994*, p. 22.

4. It is sometimes argued that the ratio of covered workers to beneficiaries overstates the burden on workers. Robert Ball and Henry Aaron, "Social Security: It *Is* Affordable," *Washington Post*, February 15, 1994, p. A17.

5. Two recent estimates place the cost of supporting the elderly at 2.5 times and 1.76 times the cost of supporting a child dependent. See Dennis A. Ahlburg and James W. Vaupel, "Immigration and the Dependency Burden" (manuscript, 1993), p. 6.

6. For example, the median age of immigrants to the United States is currently 28 years, but a 28-year-old arriving in 1990 will be 88 by 2050 and probably retired. Therefore, in order to maintain the worker-retiree ratio at its 1990 level in the year 2050, additional immigrants of working age would be needed to fill the retiree's place.

7. Thomas Espenshade, "Can Immigration Slow U.S. Population Aging?" *Journal of Policy Analysis and Management* (1994); Ahlburg and Vaupel, "Immigration and the Dependency Burden."

8. In 1988, the median government employee pension was $8,049, but many federal retirees and some state and local retirees were not eligible for Social Security benefits. Joseph S. Piacentini and Jill D. Foley, *EBRI Databook on Employee Benefits*, 2d ed. (Washington, D.C.: Employee Benefit Research Institute, 1992), p. 103.

9. Increased saving out of current income increases investment resources, whereas a rise in the market value of existing assets does not.

10. Indeed, a similar situation was engineered by one of the pension reform measures contained in the 1994 GATT-enabling legislation. The maximum interest rate that could be used to calculate pension liabilities was lowered to 105 percent of the preceding four-year weighted Treasury bond rate (from 110 percent). This will cause some pension plans that were previously fully funded to become underfunded and to have to increase contributions.

11. The term *pension coverage* refers to the percentage of workers eligible to participate in an employer- or union-sponsored pension plan. Some eligible workers choose not to participate. Although the absolute numbers of covered and participating workers differ, coverage and participation rates exhibit similar trends over time.

12. Employee Benefit Research Institute, *Pension Coverage and Participation Growth: A New Look at Primary and Supplemental Plans*, Issue Brief no. 144 (Washington, D.C.: EBRI, December 1993), p. 4. Available data from one source, the 1988 *Current Population Survey*, indicated that coverage declined slightly between 1979 and 1988, an event that raised some concern. Data for more recent periods suggest that coverage has since increased or at least leveled off. Moreover, IRS data on participation rates did not show the decline.

13. The obligation assumed by an employer in establishing a pension plan often takes one of two forms: (1) a *defined benefit plan*, whereby the employer provides specified benefits that are established in advance by formula (usually affected by wage and years of service) and financed by variable employer contributions to a pension fund, and (2) a *defined contribution plan*, whereby the annual employer contributions are specified (usually a percent of the wage) but the benefits are variable, depending on the performance of the fund. For further description, see Dan M. McGill and Donald S. Grubbs, Jr., *Fundamentals of Private Pensions*, 6th ed. (Philadelphia: Pension Research Council, Wharton School, University of Pennsylvania, 1989), p. 105.

14. David Kennell et al., *Retirement Coverage in Small and Large Firms, Final Report*, (Paper prepared for the Office of Advocacy, U.S. Small Business Administration, Washington, D.C.: June 1992), p. ES.8.

15. Based on tax status determination requests to the IRS from companies instituting new plans, it appears not only that the total number of new plans has declined but also that most of the new plans introduced have been of the defined contribution type. In 1982 alone, for example, 85,000 plan sponsors applied for favorable determination status, of whom 28,000 sponsored defined benefit plans; but in 1990, 1991, and 1992 combined, only 40,000 sponsors applied, of whom just 3,000 were of the defined benefit type. However, this measure of recent trends is not ideal because application for favorable determination status is not compulsory.

16. Those who favor defined benefit plans argue that

retirement income will be higher because fewer lump-sum distributions are made from defined benefit plans and because the professional investors who manage the plans are likely to get a higher return on investment. On the other hand, the defined contribution plans are generally fully portable, a feature that may improve retirement benefits for those who have several jobs during their working years. See Richard V. Burkhauser and Dallas L. Salisbury, eds., *Pensions in a Changing Economy*, (Washington, D.C., and Syracuse, N.Y.: Employee Benefit Research Institute and National Academy on Aging, 1993); and Andrew Samwick and Jonathan Skinner, "How Will Defined Contribution Pension Plans Affect Retirement Incomes?" (Paper prepared for conference on "Public Policy Toward Pensions,"sponsored by the Association of Private Pension and Welfare Plans and the Center for Economic Policy Research, Stanford University, Stanford, Calif.: October 7-8, 1993).

17. Available data on lump-sum distributions are discussed in Burkhauser and Salisbury, *Pensions in a Changing Economy*, pp. 27 and 43-45.

18. Employee Benefit Research Institute, "Retirement Program Lump-Sum Distributions: Hundreds of Billions in Hidden Pension Income" Issue Brief no. 146 (Washington, D.C.: EBRI, February 1994), p. 8.

19. Private pension funds will be drawn down as the baby-boom generation retires. Indeed, one projection indicates that the pension system will cease being a net source of savings by 2024. Given the magnitude of the shift, there is concern that this will have a depressing effect on asset prices. Sylvester Schieber and John Shoven, "The Consequences of Population Aging on Private Pension Fund Saving and Asset Markets," Working Paper no. 4665 (Cambridge, Mass.: National Bureau of Economic Research, March 1994).

20. The PBGC's single-employer insurance fund continues to be in deficit on a net liability basis; and at the end of 1993, PBGC liabilities ($11.3 billion) exceeded its assets ($8.4 billion) by $2.9 billion. Although ERISA states that the United States is not liable for any obligation incurred by the PBGC [Title IV Section 4002(g)(2)], Congress has behaved as if the PBGC's liabilities are the liabilities of the federal government because it wants to avoid a default on federally insured pensions. Consequently, many have concluded, as the Congressional Budget Office has, that "the federal government is almost certainly responsible for those liabilities of the PBGC that exceed PBGC's assets." CBO, *Controlling Losses of the Pension Benefit Guaranty Corporation* (Washington, D.C.: U.S. Government Printing Office, January 1993), p. 3.

21. Pension Benefit Guaranty Corporation, *Annual Report 1992* (Washington, D.C.: U.S. Government Printing Office, 1992), pp. 4 and 10; and PBGC, *Annual Report 1993* (Washington, D.C.: U.S. Government Printing Office, 1993), pp. 7, 20-21.

22. A number of alternative concepts are used to estimate pension liabilities that can significantly affect the perception of the adequacy of funding. Because of the need for federal revenues, Congressional tax-writing committees tend to choose less stringent standards of funding to determine the eligibility of contributions. For example, tax provisions of OBRA87, which had the effect of sharply reducing business contributions to pension funds, required that the calculation of maximum eligible funding be based on 150 percent of the *termination-of-plan* concept of liabilities. This concept assumes the pension is terminated at the valuation date and therefore ignores increases in obligations that will arise because of future wage increases and years of service. Broader measures of funding adequacy, such as the concept required by the Financial Accounting Standards Board (FASB Statement 87), do include projected increases in earnings and, consequently, generally show higher liabilities.

23. See Chapter 2 for recommendations for changes in the Social Security system.

24. Those single men and women who have an average wage and turn 65 years old in 1995 and 2010, respectively, will be the first cohorts with average wages to receive a negative return. Returns remain positive in those years for all but the highest-income married couples. For high-wage single individuals who turn 65 in 2010, the present value of taxes paid will exceed the annuity value of benefits by $135,000 for men and $84,000 for women. See C. Eugene Steuerle and Jon M. Bakija, *Retooling Social Security for the 21st Century* (Washington, D.C.: Urban Institute Press, 1994), p. 107.

25. The payroll tax rate for employees and employers in 1994, including Medicare, was 7.65 percent, consisting of 5.60 for retirement (OASI), 0.60 for disability (DI), and 1.45 for health (HI). Self-employed persons pay a higher rate.

26. Social Security Administration, *Annual Report of the Board of Trustees, OASDI Trust Funds, 1994*, pp. 5 and 177.

27. The full commission did not accept the Kerrey-Danforth proposals, of which the four most important in relation to Social Security were: (1) further increasing the Social Security retirement age, (2) reducing growth of initial benefits relative to earnings, (3) reducing benefits for upper-income workers, and (4) replacing part of the Social Security program with a mandatory saving program. The leadership of the 104th Congress has also indicated that no changes will be made to Social Security for the time being.

28. In August 1994, the CBO projected that the total federal deficit would be $202 billion in fiscal 1994. The OASDI surplus was expected to total $58 billion, indicating a non–Social Security debt of $260 billion. U.S. Congress, Congressional Budget Office, *The Economic and Budget Outlook: An Update* (Washington, D.C.: U.S. Government Printing Office, August 1994), p. 29. Because of

the fungibility of government income, strictly speaking, it cannot be stated that the Social Security surplus is not used to finance government investment spending instead of consumption spending. Some would like to see the annual surplus invested in private assets in an attempt to ensure that pension savings are increased, though this would not necessarily increase *national* saving. Others argue that the non–Social Security budget should be in balance so that the Social Security surpluses can be used to retire federal debt and, thereby, increase the nation's saving. See Rudolph G. Penner, *Social Security and National Saving* (New York: Committee for Economic Development, 1989).

29. Office of Management and Budget, "Budget Baseline, Historical Data and Alternatives for the Future," *Budget of the United States Government for Fiscal Year 1994* (Washington, D.C.: U.S. Government Printing Office, January 1993), pp. 187-196.

30. There have been widespread news reports about abuses involving excessively generous pensions. For example, local government pensions that base benefits on earnings during the final years of work occasionally have been manipulated by permitting workers in those final years to work long hours of overtime and to include overtime pay in earnings counted for retirement. Some federal employees also qualify for very generous pensions, often from legislative service or from combined civilian and military service.

31. Pension coverage is higher in the public sector, and benefits are sometimes more generous than in the private sector. But it is not always the case that public-sector pensions are a "better deal" for workers than private-sector pensions. Most public-sector workers are required to contribute to their defined benefit plan, whereas most private-sector workers make contributions to Social Security only. Private-sector workers are more likely to have a supplementary defined contribution plan, and many public-sector workers are not covered by Social Security. (New workers in the public sector are now required to be covered by Social Security.) A recent study of retirement income provided by defined benefit plans and Social Security found that the initial retirement income replacement ratio for typical newly retired public-sector workers not covered by Social Security was similar to or slightly better than the income replacement ratio for private-sector workers but that the contribution to pensions made by public-sector workers typically exceeded contributions made by private-sector workers. Those public-sector workers who were covered by Social Security on average had very high ratios of replacement income, but their contributions were similarly high (Table 3).

32. About half of state and local government employees covered by defined benefit pensions and all full-time federal employees are in programs that provide automatic cost-of-living increases. Social Security is also adjusted for inflation. Many private sector pensions are adjusted to compensate for inflation, but the adjustment is nearly always discretionary and frequently intermittent. William J. Wiatrowski, "On the Disparity between Private and Public Pensions," *Monthly Labor Review* (April 1994): 3-9.

33. It is also argued that automatic cost-of-living adjustments for Social Security and other pension benefits raise social costs by reducing the voting constituency that supports anti-inflationary policies.

34. Elderly income has also grown relative to that of the nonelderly as a result of economic conditions. A large share of their income has been shielded from inflation and unemployment; consequently, the elderly may be relatively well off in bad times. For example, high unemployment, high inflation, and high interest rates in the 1979–1984 period helped to reduce the real income of the nonelderly by 0.3 percent while raising the income of the elderly by 3.4 percent.

35. According to the example given in "Retirement Benefits and Saving Requirements" (see page 39), if the real return were 6 percent annually, the individual's required rate of saving to attain the same retirement income target would be only 7 percent. This illustration also presents estimates of required saving to achieve alternative replacement ratios.

36. Many managers of defined contribution pension plans fear that participants are too risk averse to invest in portfolios with higher potential returns. Educating participants about the required rate of saving and asset returns needed to attain a desired level of retirement income is increasingly emphasized. For example, TIAA-CREF, a very large defined contribution plan, encourages its members to include equities in their portfolios. Based on its historical rates of return on a fifty-fifty split between a traditional annuity and a common-stock fund, TIAA-CREF reports that a contribution of 10 percent of salary for thirty years yields a replacement rate of 50.7 percent of final pay. See John J. McCormack, Statement presented to U.S. Department of Labor, ERISA Advisory Council, Washington, D.C., September 23, 1993.

37. Employee Benefit Research Institute, *EBRI Data Book on Employee Benefits*, 2d ed. (Washington: D.C.: EBRI, 1992), pp. 28 and 36.

38. The study does concede that future retirement looks very bleak for some groups, particularly the poorly educated and single women with few marketable skills. Congressional Budget Office, *Baby Boomers in Retirement: An Early Perspective* (Washington, D.C.: U.S. Government Printing Office, September 1993).

39. Alan J. Auerbach and Laurence J. Kotlikoff, "The United States Fiscal and Savings Crisis and Their Implications for the Baby Boom Generation" (Paper presented at a policy forum sponsored by the Employee Benefit Research Institute, Washington, D.C., May 4, 1994).

40. Hilary Williamson Hoynes and Daniel McFadden, "The Impact of Demographics on Housing and Non-Housing Wealth in the United States" (National Bureau of Economic Research, Inc., Working Paper no. 4666, Cambridge, Mass., March 1994).

41. These and other arguments have led some scholars to conclude that the CBO calculations actually present a very pessimistic picture about the economic status of baby boomers in retirement. B. Douglas Bernheim, "The Adequacy of Saving for Retirement: Are the Baby Boomers on Track?" (Paper presented at EBRI Policy Forum, Washington, D.C., May 4, 1994).

42. See B. Douglas Bernheim, "Is the Baby Boom Generation Preparing Adequately for Retirement?" Technical Report, mimeographed 1992, and a "Summary Report" with the same title published by Merrill Lynch, 1993. The methodology is also discussed by Bernheim and John Karl Scholz in "Private Saving and Public Policy," *Tax Policy and the Economy*, vol. 7, ed. James M. Poterba (Cambridge, Mass.: National Bureau of Economic Research and MIT Press, 1993), pp. 76-87.

43. Karen Martin Gibler and Joseph Rabianski, "Elderly Interest in Home Equity Conversion," *Housing Policy Debate* 4, no. 4 (1993): 565-588.

CHAPTER 4

1. Over the years, CED has sponsored critical research on reforming the income tax, including perhaps the most basic source on the consumed-income tax. In the 1980s, CED commissioned a study by David Bradford, published as *Untangling the Income Tax*, a Committee for Economic Development publication, (Cambridge, Mass: Harvard University Press, 1986). Bradford described the U.S. income tax system as a hybrid that has sometimes followed the comprehensive *accrual-income theory*, which includes in the income tax base all consumption and saving, and sometimes followed the *consumed-income theory*, which does not include savings in the tax base. Bradford believes that our hybrid approach produces a muddle that is worse than would occur if we were to follow either theory consistently. He recommended moving from the accrual-income theory toward the consumption theory.

Bradford makes clear that neither theory is the *true* theory. Rather, he believes that the contending theories present a choice. The language of the debate on particular questions (e.g., taxation of pensions) is influenced mightily if one accepts one or the other theory as true. Excluding retirement savings from the tax base is described as the grant of a subsidy or incentive from the perspective of the comprehensive accrual-income theory, whereas the inclusion of those savings in the tax base is described as a penalty or disincentive from the perspective of the consumed-income theory. On page 208, Bradford states:

> There is a certain irony about the existence of saving and investment incentives in the context of an income tax, inasmuch as the principal reason for believing that special incentives for these activities are needed is the tax itself. The rules that we think of under this heading are largely aimed not at mitigating some inherent defect in the economy but at offsetting a problem created by the tax system in the first place: namely, the disincentive effect of income taxes on saving and investing.

Describing tax-qualified savings as an *incentive* (under the comprehensive accrual-income theory) may also contribute to excessive and complicated regulation of what is deemed to be a special exception. Under the consumption theory, the exclusion of savings from the tax base is treated as normal, not a special exception, and therefore is less likely to be subject to overregulation.

2. The federal government's classification of the deferral of taxes on pension savings as a *tax expenditure* is consistent with the income tax view, not the consumed-income view. (See "Tax Expenditures and Pension Tax Preferences," page 46.)

3. *Target* savers are likely to be low-income individuals who save the minimum needed for a specific purpose, such as a down payment on an automobile or an appliance, whereas those who increase savings in response to a higher return are likely to be higher-income earners who have discretion to save for more than minimum future consumption.

4. See, for example, Stephen F. Venti and David A. Wise, "IRAs and Saving," in *The Effects of Taxation on Capital Accumulation*, ed. Martin Feldstein (Chicago: University of Chicago Press, 1987), pp. 7-40; and James Poterba, Steven F. Venti, and David A. Wise, "401(k) Plans and Tax-Deferred Saving," National Bureau of Economic Research, Working Paper no. 4181 (Cambridge, Mass.: NBER, October 1992).

5. Poterba, Venti and Wise, "401(k) Plans and Tax-Deferred Saving."

6. This is because the positive impact on savings resulting from the increased return will dominate over the shifting of savings as funds available for shifting decline. See Eric M. Engen, William G. Gale, and John Karl Scholz, "Do Saving Incentives Work?" in *Brookings Papers on Economic Activity*, vol 1., ed. William C. Brainard and George L. Perry (Washington, D.C.: Brookings Institution, 1994), pp. 85-152.

7. To promote household saving, Bernheim and Scholz proposed *premium saving accounts* (PSAs) as an alternative to IRAs. A PSA would require each taxpayer to save in total some fixed amount before becoming eligible to make contributions to a tax-preferred account. The amount of eligible contributions would vary with adjusted gross income. B. Douglas Bernheim and John Karl

Scholz, "Private Saving and Public Policy," in *Tax Policy and the Economy*, ed. James Poterba (Cambridge, Mass.: NBER, 1993), p. 98.

8. B. Douglas Bernheim and John Karl Scholz, "Private Saving and Public Policy," National Bureau of Economic Research, Working Paper no. 4215 (Cambridge, Mass.: NBER, November 1992), p. 24.

9. Alicia Munnell, "It's Time to Tax Employee Benefits," *New England Economic Review* (July-August 1989): 49-63.

10. Some researchers have also found that policies that reduce pension tax benefits are likely to increase inequality in the distribution of *wealth*. See Robert L. Clark and Elisa Wolper, "Pension Tax Expenditures: Magnitude Distribution and Economic Effect," (Paper prepared for conference on "Public Policy Toward Pensions," sponsored by the Association for Private Pension and Welfare Plans and the Center for Economic Policy Research, Stanford University, October 1993).

11. The advantages and disadvantages of compulsory saving plans are discussed in William G. Gale and Robert E. Litan, "Saving Our Way Out of the Deficit Dilemma," *The Brookings Review* (Fall 1993): 7-11.

12. This has occurred yet again in the 1994 legislation enabling GATT. For example, one measure effectively delays indexation of pension benefit and contribution limits purely as a revenue-raising measure. (See Retirement Protection Act of 1994, Title VII, Section 732).

13. For the most recent CED statement on the budget deficit, see *Restoring Prosperity: Budget Choices for Economic Growth* (1992), p. 2.

14. See *Restoring Prosperity: Budget Choices for Economic Growth*, pp. 6-7.

CHAPTER 5

1. Pension plans for public-sector employees are not covered under the federal laws governing private plans.

2. Employee Benefit Research Institute, *Pension Funding and Taxation: Implications for Tomorrow* (Washington, DC: EBRI, 1994), p. 44.

3. Many propose that the United States abandon the current practice of taxing income and adopt a consumption-based tax system, which would exempt all saving from taxation. In such a system the limits on tax preferences would not be necessary. (See Chapter 4.)

4. American Council of Life Insurance, *The Pension Legacy: The Case for Preserving the Private Pension System* (Washington, D.C.: 1993), p. 6.

5. A forfeiture is a situation whereby an individual ceases employment before being vested with the pension benefits.

6. See William G. Gale, "Public Policies and Private Pension Contributions," *Journal of Money, Credit, and Banking*, forthcoming; and Scott B. Smart and Joel Waldfogel, "Tax Policy, Saving, and Pension Funding" (manuscript, Indiana University, October 1992).

7. Sylvester J. Schieber and John B. Shoven, *The Consequences of Population Aging on Private Pension Fund Saving and Asset Markets*, CEPR Technical Paper no. 363 (Stanford, Calif.: Center for Economic Policy Research, Stanford University, September 1993), p. 12. A 1989 survey by Mercer-Meidinger-Hansen found comparable results. See William M. Mercer-Meidinger-Hansen, *The Effect of OBRA on Pension Plans: A Survey* (New York: William M. Mercer-Meidinger-Hansen, 1989).

8. Contributions to defined contribution plans were capped at $30,000 until the indexed benefit limit for defined benefit plans reaches $120,000. Contributions have also been reduced by limits on considered compensation.

9. If an employee participates in a defined benefit *and* a defined contribution plan, a special overall limitation on contributions and benefits is applied. This limit uses a complicated formula based on the limits for individual plans. Thus, if the individual-plan limits are changed, the multiple-plan limit also changes.

10. This limit applies to annuities; if a lump sum is involved, the limit is $742,000.

11. Emily S. Andrews, "The Growth and Distribution of 401(k) Plans," in U.S. Department of Labor, Pension and Welfare Benefits Administration, *Trends in Pensions 1992* (Washington, D.C.: U.S. Government Printing Office, 1992), p. 164.

12. Section 403(b) plans (see "Defined Contribution Plans, pp. 54-55) already include a catch-up provision that allows additional employer and employee deferrals for individuals who have been with an employer fifteen years. However, these plans are available only to nonprofit organizations and educational institutions.

13. There is also a family aggregation rule, which stipulates a combined $150,000 limit for a married couple if they both work for the same employer and one spouse is in the top group of highly compensated employees.

14. For example, in a defined benefit plan, an individual earning $175,000 and participating in a plan that specifies a pension benefit of 40 percent of salary would be credited with only 40 percent of $150,000 under the new rule, a $10,000 reduction in retirement benefit. Of course, because the contributions are limited, benefits are reduced accordingly.

15. They are referred to as the *actual deferral percentage tests*: (1) The average percentage of compensation deferred (i.e., contributed to the plan) for the highly compensated group cannot exceed 125 percent of the average

deferral percentage for the low-paid group. (2) The average deferral percentage for the highly compensated group cannot be more than two times that of the other group, and the difference between the percentages cannot be more than 2 percent. Matching employer contributions are subject to similar tests under Section 401(m) of the Internal Revenue Code.

16. In the case of saving plans with matching employer-employee contributions, nondiscrimination rules would require that the employer contribution be a uniform percent of the contribution made by individual employees. Retention of a ceiling on contributions to *secondary* 401(k) plans would prevent highly compensated employees from gaining an inordinately large benefit from this arrangement

17. John Trutko and John Gibson et al. *Cost and Impact of Federal Regulation on Small Versus Large Business Retirement Plans*, *Final Report* (submitted to the Office of the Chief Counsel for Advocacy, Small Business Administration, June 1990), p. 66.

18. A pension plan had to satisfy one of these tests in order to be in compliance:

1. Percentage test: The plan must cover at least 70 percent of all non–highly compensated employees.
2. Ratio test: The percentage of non–highly compensated employees covered under a plan must be at least 70 percent of the percentage of highly compensated employees covered.
3. Average benefits percentage test: Both of the follow ing must be satisfied to pass this test:
   a. The plan must cover a nondiscriminatory classification of employees.
   b. The ratio of employer-provided benefits or contributions to the participant's compensation for non–highly compensated employees must be at least 70 percent that of highly compensated employees.

19. The participation rule requires that no individual who has reached the age of 21 and has one year of service can be excluded from a plan. Employees must, at a minimum, be vested according to one of two schedules: (1) five-year cliff or (2) 20 percent after three years and an additional 20 percent for each of the next four years.

20. Independent projections by the Office of Management and Budget put the PBGC's exposure at about $24 billion over the next thirty to forty years.

21. Changes in a plan's unfunded liability arising from an increase in plan benefits can be amortized over thirty years. Losses or gains resulting from changes in actuarial assumptions can be amortized over ten years; experience losses or gains can be amortized over five years. There are a number of other amortization schedules that apply to other categories of gains and losses. The Retirement Protection Act of 1994 speeds up amortization of different kinds of unfunded liabilities but also further complicates the amortization schedules.

22. McGill and Grubbs, *Fundamentals of Private Pensions*, p. 611.

23. Carolyn L. Weaver, "Government Guarantees of Private Pension Benefits: Current Problems and Likely Future Prospects" (Paper prepared for conference on "Public Policy Towards Pensions," sponsored by the Association of Private Pension and Welfare Plans and the Center for Economic Policy Research, Stanford University, September 1993), pp. 13-14.

24. Weaver, "Government Guarantees of Private Pension Benefits: Current Problems and Likely Future Prospects," pp. 14-15.

25. Pension Benefit Guaranty Corporation, *Annual Report 1992* (Washington, D.C.: U.S. Government Printing Office, 1992), p. 11.

26. The Retirement Protection Act of 1994 gives the PBGC authority to sue plan sponsors to enforce minimum-funding standards where contributions are deficient by more than $1 million.

27. Celia Silverman and Paul Yakoboski, "Public and Private Pensions Today: An Overview of the System," in *Pension Funding and Taxation: Implications for Tomorrow*, ed. Dallas L. Salisbury and Nora Super Jones (Washington, D.C.: EBRI, 1994), p. 19.

28. Hay/Huggins Company, Inc., *Pension Plan Expense Study for the Pension Benefit Guaranty Corporation* (Washington, D.C.: Hay/Huggins, September 1990).

29. Small plans are at a significant cost disadvantage in trying to comply with constantly changing regulations because the variable costs of plan administration are not closely linked to the number of participants. Pension plan service providers typically charge a fixed fee plus a per-participant fee; however, the latter may be reduced if the number of plan participants exceeds a threshold. See Trutko and Gibson et al., *Cost and Impact of Federal Regulation on Small Versus Large Business Retirement Plans*, p. 74.

30. The two plan sizes considered were 25 and 200 participants. Trutko and Gibson et al., p. 80.

31. These changes include OBRA93, which further reduced considered compensation, and requires complicated calculations for compliance. See pages 57-59 of this document.

32. Another 7 percent cited limitations on benefits to owners resulting from regulations governing maximum benefits, considered compensation, and nondiscrimination. Other major reasons were plant shutdowns or uncertainty of employer income (22 percent) and employer/

employee preferences (17 percent). David Kennell et al. *Retirement Plan Coverage in Small and Large Firms, Final Report* (submitted to Office of Advocacy, U.S. Small Business Administration, June 1992), Table III-19. See also Trutko and Gibson et al., pp. 60-61.

33. Although many workers were left without coverage because of the failure of employers to form successor plans, the rapid decline in pension coverage under defined benefit plans cannot be attributed exclusively to regulation. In addition to administrative costs, researchers believe that labor market shifts have been a crucial factor: A decreasing number of workers are in industries dominated by large, unionized firms that traditionally sponsor defined benefit plans. Daniel J. Beller and Helen H. Lawrence, "Trends in Private Pension Plan Coverage" in U.S. Department of Labor, Pension and Welfare Benefits Administration, *Trends in Pensions 1992* (Washington, D.C.: U.S. Government Printing Office, 1992), p. 70.

34. The impact of regulatory reform on the formation of defined benefit plans by very small firms may be less critical. Many smaller firms still do not offer their employees any pension plan. Evidently, economic factors such as uncertainty about income have much to do with this. Smaller firms also tend to have a greater percentage of employees who are young, part-time, and/or not likely to stay for a long period in their job. See Kennell et al., *Retirement Plan Coverage in Small and Large Firms, Final Report*, p. ES.8.

APPENDIX

1. Where the plan provides for full immediate vesting, the employer can require three years of service. Also, employees who begin service before age 25 can have three years of that service credited toward vesting when they attain 25.

2. The vesting grades were now as follows: at least 25 percent after five years, increasing by 5 percent in each of the following five years and 10 percent annually in the third five-year tranche.

3. However, an employee with ten years of service must be 50 percent vested even if the sum of age and service does not exceed 45.

4. The normal cost of a pension plan in a particular year is the cost of benefits accrued in that year.

5. A *money purchase plan* is a defined contribution plan whereby periodic contributions are made according to a formula, usually a percent of salary. Some plans may require contributions by the employee as well as the employer. A *profit-sharing plan* is another type of defined contribution plan, with the distinctive characteristic that contributions are likely to be variable because they are tied to a firm's profits.

6. The most common type of 401(k) plan entails an employee salary reduction, the amount of which is placed in a tax-deferred account. About half of these plans involve some amount of matching employer contribution.

7. The contribution limit for SEPs is now the lesser of $30,000 or 15 percent of compensation.

8. Under a leveraged ESOP, the plan's trustee takes out a loan and uses it to purchase employer stock, which itself is pledged as collateral for the loan. As repayments of principal are made on the loan, stock can be released as collateral and allocated to employee accounts.

9. Down from $45,475.

10. Previously 7 percent.

11. The major rules are as follows:

a. Vesting: Either three-year cliff or graded to achieve full vesting after six years.

b. Minimum benefits: For nonkey employees, the minimum annual benefit from a defined benefit plan was set at the lesser of 20 percent of average compensation or 2 percent of average compensation multiplied by the number of years of service.

c. Minimum contributions: For nonkey employees, the minimum contribution to a defined contribution plan was set at the lesser of 3 percent of cash compensation or the highest contribution rate for a key employee.

d. Considered compensation: Only the first $200,000 of compensation could be taken into account when calculating benefits.

e. Social Security integration: Neither Social Security benefits nor taxes could be counted against minimum pension benefits.

f. Aggregate benefit and contribution limits on multiple plans: Normally, if an employer operates a plan of each type (i.e., one defined contribution and one defined benefit), the total benefits and contributions cannot exceed 140 percent of the limit governing one plan if the percentage of compensation limit applies or 125 percent of the limit if the dollar limit applies. For top-heavy plans that would otherwise come under the 125 percent rule, benefits and contributions from multiple plans were reduced to 100 percent unless minimum benefits and contributions for nonkey employees are increased 1 percentage point and no more than 90 percent of benefits and account balances is designated to key employees.

12. However, the plan was made liable to the PBGC for the sum of total unfunded benefits up to 30 percent of net worth and the excess (if any) of 75 percent of all unfunded benefits minus 30 percent of net worth.

13. An integrated defined benefit excess plan is one that

provides a higher percentage of benefits for earnings above the integration level than for earnings below the integration level. Under prior law, it was possible to design a plan so that there was no benefit below the integration level.

14. Here the integration level is defined as *covered compensation*. Covered compensation is the average Social Security taxable earnings base for the thirty-five years immediately preceding the participant's normal retirement age.

15. Defined as a plan in which the benefit attributable to employer contributions is reduced by a specified amount.

16. TRA also introduced a definition of highly compensated employee that differed from that in the top-heavy rules contained in TEFRA.

17. This is a subjective test administered by the IRS.

18. The deficit reduction contribution consisted of two parts: (1) the amount necessary to amortize unfunded old liability in equal annual installments over eighteen years and (2) a percentage of unfunded liability relating to the current plan year.

19. Unpredictable contingent event benefits are benefits promised in the event of the closure of a facility or some other occurrence that cannot be reliably anticipated.

20. Reduced from 10 percent above the same average.

21. Amortization of increases in current liability as a result of the new rules regarding the allowable interest rates and mortality table had to be amortized in equal annual installments over a twelve-year period beginning in 1995.

MEMORANDUM OF COMMENT, RESERVATION, OR DISSENT

Page 14, JAMES Q. RIORDAN

The report is excellent and timely. The U.S. retirement system is indeed underfunded, overpromised, and overregulated. As a result we have less savings for retirement than we need. This is, however, a special case of the more general problem that government policy generally discourages savings and encourages consumption. CED has long warned about the lack of savings and the consequences of government dissaving (deficits). The deficit has, at times, shown a year-to-year decline in the last decade; but in the best of years it has been too large, and the outlook is bleak.

If net saving is to increase, it will need to come from increased private saving — including increased retirement savings.

The report makes many excellent incremental suggestions to improve the tax and regulatory scheme governing retirement savings. I wish, however, that we had recommended a more fundamental cure for our problem. The report properly puts the retirement savings issue in the context of the debate now going forward on whether savings of any kind should be included in the income tax base. Indeed it briefly states the case for moving to a tax system that does not include private saving in the income tax base. Unfortunately, it does not carry the discussion to its logical conclusion and instead makes the assumption that the government will persist in accepting as revealed wisdom the comprehensive accrual-income theory that treats every instance of deferred taxation on savings as a preference. The assumption has led the report to accept continuing limits and regulatory complications that will limit the increase in savings. It inevitably leads to the use of language that distorts the dialogue. I wish that we had grasped the nettle and recommended taxing consumption and not savings.

Nevertheless, this is a fine report, and I hope that all of the improvements recommended will be adopted.

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Close relations exist between the Committee for Economic Development and independent, nonpolitical research organizations in other countries. Such counterpart groups are composed of business executives and scholars and have objectives similar to those of CED, which they pursue by similarly objective methods. CED cooperates with these organizations on research and study projects of common interest to the various countries concerned. This program has resulted in a number of joint policy statements involving such international matters as energy, East-West trade, assistance to developing countries, and the reduction of nontariff barriers to trade.

CE	Circulo de Empresarios Madrid, Spain
CEDA	Committee for Economic Development of Australia Sydney, Australia
EVA	Centre for Finnish Business and Policy Studies Helsinki, Finland
FAE	Forum de Administradores de Empresas Lisbon, Portugal
IDW	Institut der Deutschen Wirtschaft Cologne, Germany
IE	Institut de l'Entreprise Brussels, Belgium
IE	Institut de l'Entreprise Paris, France
経済同友会	Keizai Doyukai Tokyo, Japan
SMO	Stichting Maatschappij en Onderneming The Netherlands
SNS	Studieförbundet Naringsliv och Samhälle Stockholm, Sweden